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THE BUDGET DEFICIT, THE STATE OF THE U.S. ECONOMY, AND FEDERAL BUDGET POLICY FOR FISCAL YEAR 1990 AND BEYOND

HEARINGS

BEFORE THE

COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES

ONE HUNDRED FIRST CONGRESS

FIRST SESSION

FEBRUARY 7, 8, AND 9; AND MARCH 7, 8, AND 15, 1989

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THE BUDGET DEFICIT, THE STATE OF THE U.S. ECONOMY, AND FEDERAL BUDGET POLICY FOR FISCAL YEAR 1990 AND BEYOND

TUESDAY, FEBRUARY 7, 1989

House of Representatives,
Committee on Ways and Means,
Washington, D.C.

The committee met, pursuant to notice, at 10:02 a.m., in room 1100, Longworth House Office Building, Hon. Dan Rostenkowski (chairman of the committee) presiding.

[The press releases announcing the hearings follow:]

FOR IMMEDIATE RELEASE
TUESDAY, DECEMBER 6, 1988

PRESS RELEASE #31
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
1102 LONGWORTH HOUSE OFFICE BUILDING
WASHINGTON, D.C. 20515
TELEPHONE: (202) 225-3625

THE HONORABLE DAN ROSTENKOWSKI (D., ILL.), CHAIRMAN, COMMITTEE ON WAYS AND MEANS, U.S. HOUSE OF REPRESENTATIVES, ANNOUNCES PUBLIC HEARINGS ON THE BUDGET DEFICIT, THE STATE OF THE U.S. ECONOMY AND FEDERAL BUDGET POLICY FOR FISCAL YEAR 1990 AND BEYOND

The Honorable Dan Rostenkowski (D., Ill.), Chairman, Committee on Ways and Means, U.S. House of Representatives, today announced the Committee will hold three days of public hearings on the budget deficit, the economy and the need for deficit reduction. The hearings will be held on Tuesday, February 7, Wednesday, February 8, and Thursday, February 9, 1989, in the Committee's main hearing room, 1100 Longworth House Office Building, beginning at 10:00 a.m. each day.

The Committee will receive testimony from invited witnesses only at these preliminary hearings. Additional hearings will be scheduled on specific budget proposals at which public witnesses will be given the opportunity to testify. The Committee will also schedule hearings to accomodate President Bush's budget proposals at such time as they may be available.

In announcing these hearings, Chairman Rostenkowski stated: "I am seriously concerned about our Nation's economic future and believe that we need to move as quickly as possible to reduce the Federal budget deficit. Changes in fiscal policy will be necessary to help achieve a path of strong economic growth for the future. As we begin the budget process for fiscal year 1990, it is important for the Committee to understand how the Nation's economy is performing and the economic impact of the deficit. What are the implications of our huge stockpile of foreign-held debt? What does the low U.S. savings rate imply for future economic growth and the standard of living of future generations of Americans? How can reductions in the deficit be structured to encourage savings and investment? Also, the Committee needs to consider the economic implications of achieving the Gramm-Rudman deficit target path, and consider whether, and how, the Social Security and Medicare trust fund surpluses should be counted toward reaching deficit reduction goals."

DETAILS FOR SUBMISSION OF WRITTEN COMMENTS:

Any interested person or organization may file written comments for inclusion in the printed record of the hearings. Persons submitting written comments for the printed record should submit at least six (6) copies by the close of business, Friday, March 24, 1988, to Robert J. Leonard, Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515.

FORMATTING REQUIREMENTS:

Each statement presented for printing to the Committee by a witness. any written statement or exhibit submitted for the printed record or any written comments in response to a request for written comments must conform to the guidelines listed below. Any statement or exhibit not in compliance with these guidelines will not be printed. but will be maintained in the Committee files for review and use by the Committee.

1. All statements and any accompanying exhibits for printing must be typed in single space on legal-size paper and may not exceed a total of 10 pages.
2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead. exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.
3. Statements must contain the name and capacity in which the witness will appear or. for written comments. the name and capacity of the person submitting the statement. as well as any clients or persons. or any organization for whom the witness appears or for whom the statement is submitted.
4. A supplemental sheet must accompany each statement listing the name. full address. a telephone number where the witness or the designated representative may be reached and a topical outline or summary of the comments and recommendations in the full statement. This supplemental sheet will not be included in the printed record.

The above restrictions and limitations apply only to material being submitted for printing. Statements and exhibits or supplementary material submitted solely for distribution to the Members. the press and public during the course of a public hearing. may be submitted in other forms.

FOR IMMEDIATE RELEASE
FRIDAY, FEBRUARY 17, 1989

PRESS RELEASE #5
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
1102 LONGWORTH HOUSE OFFICE BLDG.
WASHINGTON, D.C. 20515
TELEPHONE: (202) 225-1721

THE HONORABLE DAN ROSTENKOWSKI (D., ILL.), CHAIRMAN, COMMITTEE ON WAYS AND MEANS, U.S. HOUSE OF REPRESENTATIVES, ANNOUNCES THE CONTINUATION OF HEARINGS, WITH ADMINISTRATION OFFICIALS, ON THE BUDGET DEFICIT, THE STATE OF THE U.S. ECONOMY AND FEDERAL BUDGET POLICY FOR FISCAL YEAR 1990 AND BEYOND

The Honorable Dan Rostenkowski (D., Ill.), Chairman, Committee on Ways and Means, U.S. House of Representatives, today announced that the Committee will continue its series of hearings on the budget deficit, the economy and the need for deficit reduction on Tuesday, March 7, and Wednesday, March 8, 1989, beginning at 10:00 a.m. each day, in the main Committee hearing room, 1100 Longworth House Office Building.

The Committee will receive testimony from the Honorable Richard Darman, Director of the Office of Management and Budget, the Honorable Louis W. Sullivan, Secretary-Designate of the Department of Health and Human Services (pending his confirmation), the Honorable Nicholas F. Brady, Secretary of the Department of the Treasury, and the Honorable Michael J. Boskin, Chairman of the Council of Economic Advisors.

In announcing the continuation of these hearings, Chairman Rostenkowski stated: "The Committee on Ways and Means needs to learn first-hand from the primary Administration policy makers the Administration's justifications for the outlay and revenue proposals contained in the President's budget. Are the proposals to make a "kinder, gentler" America adequately funded? The Committee is also interested in the economic outlook and the basis for the economic assumptions included in the President's budget. In addition, the Committee is interested in whether enactment of these proposals place the Federal deficit on a clear downward path consistent with the Gramm-Rudman-Hollings deficit targets. The Committee wants to examine the chances that the OMB deficit projection on August 25th will be below $110 billion, and thus avoid sequestration. Further, we hope to gain a longer-term perspective on the economy and future budget deficits, including the prospects for continued economic growth and rising real incomes for all segments of the population. The Committee welcomes suggestions, and will question witnesses, on how to effectively pursue fiscal policy to meet these economic goals."

BACKGROUND:

On December 6, 1988, Chairman Rostenkowski issued a press release announcing hearings on the budget deficit, the economy and the need for deficit reduction. On February 7, February 8 and February 9, 1989, the Committee held three days of hearings on these issues, receiving testimony from witnesses invited to testify before the Committee.

(MORE)

The purpose of these hearings is to afford an opportunity to the Administration's chief policy makers to present President Bush's budget proposals to the Committee and to begin the public debate on the Administration's priorities.

DETAILS FOR SUBMISSION OF WRITTEN COMMENTS:

Any interested person or organization may file written comments for inclusion in the printed record of the hearings. Persons submitting written comments for the printed record should submit at least six (6) copies of their comments by the close of business on Friday, March 24, 1989, to Robert J. Leonard, Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515.

FORMATTING REQUIREMENTS:

Each statement presented for printing to the Committee by a witness, any written statement or exhibit submitted for the printed record or any written comments in response to a request for written comments must conform to the guidelines listed below. Any statement or exhibit not in compliance with these guidelines will not be printed, but will be maintained in the Committee files for review and use by the Committee.

1. All statements and any accompanying exhibits for printing must be typed in single space on legal-size paper and may not exceed a total of 10 pages.
2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.
3. Statements must contain the name and capacity in which the witness will appear or, for written comments, the name and capacity of the person submitting the statement, as well as any clients or persons, or any organization for whom the witness appears or for whom the statement is submitted.
4. A supplemental sheet must accompany each statement listing the name, full address, a telephone number where the witness or the designated representative may be reached and a topical outline or summary of the comments and recommendations in the full statement. This supplemental sheet will not be included in the printed record.

The above restrictions and limitations apply only to material being submitted for printing. Statements and exhibits or supplementary material submitted solely for distribution to the Members, the press and public during the course of a public hearing, may be submitted in other forms.

Chairman **Rostenkowski**. The committee will come to order.

For the next 3 days, the committee will hear testimony from a variety of invited witnesses on the state of the Nation's economy. Since the election, the word "deficit" has become a part of everyone's vocabulary around Capitol Hill.

It has become the single most pressing issue that the Federal Government must deal with in the new session. Although no single simple solution to the deficit problem is evident, Congress repeatedly hears one instruction. We must address this problem and address it soon. We must reduce the deficit so that our children will not have to dig us out of our debts.

At the same time, we must maintain a healthy economy, as that will assist in deficit reduction more than anything. Those of us on Capitol Hill are optimistic about the course of upcoming budget negotiations with the new administration, and I believe that the Congress and the administration can reach a reasonable agreement that would reduce the deficit to meet the Gramm-Rudman targets for fiscal year 1990, and set the course for a balanced budget.

In the next few days we want to discuss the feasibility of this goal and how to meet it. Before this year is over, the members of this committee will have to make some very tough decisions if we want to achieve true deficit reduction. Much of it will have to happen right here in this room.

The purpose of these hearings is to set the framework for those difficult votes ahead. I have made no secret about my belief that a deficit reduction package must include both reductions in spending and increased revenue.

I await the budget recommendations from President Bush, with the hopes that he will deal with these budget issues justly, fairly, and honestly.

I do not want to have to find my way through blue smoke and mirrors.

I also agree with the President, that there is pent-up demand for new spending and for new revenue-loosening proposals to help a kinder, gentler America.

While it is difficult to think of spending more money at a time when our deficit is so large, I think that we must keep in mind that new programs, however worthwhile, must be paid for.

Hopefully, at the conclusion of these hearings, we will all have a clearer picture of the state of our economy, and the steps we need to take to reduce the budget deficit and to assure economic growth.

This morning, we will be hearing from the codirectors of the American Agenda, Stuart Eizenstat and James Cannon. Former Presidents Gerald Ford and Jimmy Carter, along with many of the officials from their respective administrations, put together a report last year that they presented to the new President. We need to duplicate that bipartisan effort if we are to solve some of our Nation's most pressing problems.

They identified six major priority areas, three of which concern the Committee on Ways and Means.

Mr. Eizenstat, Mr. Cannon, welcome to the committee. We look forward to hearing your recommendations.

STATEMENT OF STUART E. EIZENSTAT AND JAMES M. CANNON, CODIRECTORS, THE AMERICAN AGENDA, FORMER PRESIDENTIAL ADVISERS

Mr. EIZENSTAT. Thank you for the invitation, Mr. Chairman. I will give a summary of our remarks, and Mr. Cannon will have some very brief additional comments.

We appreciate the opportunity to appear before you to discuss our report, with particular emphasis on those issues which come within your broad jurisdiction.

We conceived and organized the American Agenda a year ago as a bipartisan group under the chairmanship of former Presidents Carter and Ford, with several purposes in mind.

It was our conviction, that if a group of experienced former top Government officials could identify the key issues a new President would likely face early in his term, many of which would not be considered in the Presidential campaign, it would help him more properly get on top of them.

We also believed that transitions were not a time for rest and relaxation but were rather critical decisionmaking periods which could have a great influence on the success of the new President.

We felt, having been involved in transitions ourselves, that we could offer some pointed advice about how to productively use a transition period.

The third objective was to make effective use of the wisdom and experience of two former Presidents, what they had learned from both their failures and their successes, for the benefit of the next President.

We relegate our former Chief Executives to the political equivalent of an elephant burial ground never to be heard from again. We believed that both former Presidents had something to say about the challenges facing this country and your committee.

And last, we believed—and our beliefs were confirmed even beyond our initial expectations—there were many areas of bipartisan convergence on the major issues of the day. And by illuminating them, we could make it easier for the next President to develop a bipartisan consensus with the Congress to solve some of our country's most pressing problems.

We divided our task into five subject matter panels, each cochaired by a prominent Democrat and Republican from our executive committee, and then, over the better part of a year these panels convened meetings of experts from around the country, and commissioned papers from dozens of our Nation's best minds.

In total, Mr. Chairman, over 300 people were involved, including a number of Members of Congress in our work.

Each of the five panels selected their priorities and drafted a report, and then the two Presidents selected six priority issues for immediate action, and six others for long-term consideration.

For immediate action were deficit reduction, suggestions for arms control, the defense budget and defense management; prompt solution of the savings and loan crisis; recommendations on trade and Third World debt relief; attacking the growing problem of children in poverty and concrete suggestions for bolstering relations with our allies.

In the longer term category were productivity and competitiveness, United States-Soviet relations, relations with Mexico, Nicaragua, and Central America, the global environment, and drugs.

Permit me now to focus, Mr. Chairman, on a few issues in which this committee would be most interested because of its jurisdiction. First, the budget deficit.

It is a common consensus of the two Presidents and of our executive committee, that reducing the budget deficit and balancing the unified Federal deficit by the mid-1990's was the single most important issue facing the next administration and the next Congress.

If the deficit could not be successfully tackled, little else could be accomplished. We would not have an economy strong enough to increase our living standards, to produce the revenues needed for vital domestic and defense needs, and to allow us to project our country's leadership in foreign and international economic policy.

Our deficit was a symbol of our own country's inability to match our demands with our willingness to pay for them. The two Presidents, each of whom had themselves struggled with the deficit, were horrified at deficits three or four times higher than they had ever had during their terms.

They saw the accumulated debt as stealing increasingly large amounts of hard-earned taxpayers' dollars, and more and more going to service the deficit, now one in every seven budget dollars.

They believed that these large deficits, Mr. Chairman, and members of the committee, were a principal cause of our unacceptably high trade deficits, and saw the deficits as leading to a loss of control over our own economic future as we increasingly financed the deficit from foreign investors.

We examined three budget reduction options prepared by the cochairs of our economic panel, Alice Rivlin and Paul O'Neill.

All were based on fairly optimistic assumptions of moderate, real growth over the next 4 years without a recession; moderate inflation and gradually falling interest rates, although not nearly as rosy a picture as in the Reagan assumption.

One option was similar to Mr. Bush's freeze option, and looked at what measures would be necessary if there were no tax increases, no Social Security cuts, and no real reductions in defense spending.

Mr. Chairman, we came to the conclusion that in order to achieve the Gramm-Rudman targets with that scenario, it will require holding domestic discretionary spending for 5 years at 1988 dollars, cutting Medicaid and Medicare by 20 percent from projected levels; cutting cost-of-living adjustments for Federal workers and retirees for 5 full years; and even then, Mr. Chairman, we would still be $40 billion short of the Gramm-Rudman in 1993, even under relatively optimistic scenarios.

It would mean taking disproportionate cuts in the small slice of the budget made up of discretionary domestic spending which has already borne such a heavy burden over the past 8 years and would leave no room, whatsoever, for the needed domestic investments, many of which President Bush himself has called for, and which the two Presidents recommended elsewhere in our report.

Another option produced by our economic panel had large tax increases, a 1 percent real increase in defense spending, some domestic cuts, and by fiscal year 1993, $20 billion in spending for productivity-enhancing programs.

The heart of this option, Mr. Chairman, and members of the committee, was a 5 percent value-added tax with exceptions to correct for regressiveness. Such a tax by 1993 would have raised about $73 billion annually.

In addition, this so-called tax option would have had a gasoline tax rising to 20 cents per gallon, a doubling of the cigarette tax, and increasing the tax rate on beer, wine, and alcohol equivalent, to the alcohol equivalent of distilled spirits.

The two Presidents did not accept this option, nor did they accept the first option. They felt that these large tax increases were unachievable politically, and undesirable in their potential impact on the economy, and they also felt that a value-added tax required a great deal of additional study by this committee and others before anyone could confidently recommend it.

A third option proposed a 1 percent real cut in defense, combined with $50 billion in domestic cuts from Medicare, and a variety of subsidies, and more moderate taxes, consisting of a cigarette and alcohol increase, a 20-cent gasoline tax, and a tax on 85 percent of Social Security benefits.

Rather than accepting this third option, or, indeed, the other two, the two Presidents developed their own option based on the need—and I think this is an important point, Mr. Chairman—for both deficit reduction and for additional spending in selected areas of domestic investment, particularly for poor young children and a productivity package.

The major components of our program were as follows: holding the line on defense spending to inflation; a 2 percent reduction in the cost-of-living adjustment for Social Security and Federal retirement beneficiaries; a Medicare cap on fees for physicians; a 5 percent reduction in agricultural target prices; a variety of reductions in lower priority domestic programs like Amtrak subsidies and the Economic Development Administration; And consumption taxes consisting of a 6-cent rise in the motor fuel tax, a doubling of the cigarette tax, and a rise in beer and wine taxes.

We felt, Mr. Chairman, and members of the committee, this was the only way that you could simultaneously achieve both deficit reduction and have some nest egg for additional needed spending.

They were also willing—the two Presidents—to consider additional deficit reduction measures, if needed, such as taxing 85 percent of Social Security benefits.

Now, we recognize that if you make rosy enough economic assumptions it was possible to achieve the $100 billion Gramm-Rudman target in fiscal 1990 without any tax increases, but these targets could not be reached, realistically, over a 4-year period without taxes, and even in fiscal 1990, revenue increases would be needed to make the additional investments in education, the environment, job training, research and development, all of which were desirable, let alone to meet the short-term crisis of FSLIC.

The two Presidents believed that the consumption taxes they recommended had multiple benefits. They would reduce the deficit, provide some of the revenues needed for our pressing domestic needs, and, at the same time, reduce the consumption of items that neither contributed to the health of individual Americans or to the Nation as a whole.

A second issue within the committee's jurisdiction involved what we call children at risk. The two Presidents and American Agenda's domestic panel, cochaired by former Senator Muskie and by Carla Hills, were moved by the compelling facts presented by a variety of experts of varying ideologies about the continued high level of poverty in the United States, particularly among children, despite 6 years of economic recovery and the implications this had been for the future of our country.

The figures, Mr. Chairman, and members of the committee, were stark. Thirty-three million Americans are in poverty, 13 million of whom are children.

In the United States today, one child in five is poor, a staggering figure for the world's, and, indeed, history's richest Nation. About one-third of the poor are elderly and disabled. Another third is temporarily poor due to a loss of job or some other misfortune.

And the last third live in households that are chronically poor, even though the head of household is neither elderly nor poor himself.

Mr. Chairman, leading experts told us that there are no clear answers to deal with the chronically poor. They urged us to focus on two groups where there were clearer solutions which would work, on top of the excellent work that you and your committee did last year on welfare reform, and that was children at risk and the working poor.

Our domestic panel suggested a variety of options to help the working poor. Some 47 percent of all poor households are headed by someone who works at least part of the time and 15 percent by someone who works full-time, but yet still remains poor.

Our options included an increase in the minimum wage, and in your committee's jurisdiction, a more targeted and less inflationary approach, and that is through a more generous earned income-tax credit varied by family size.

This is a very nicely focused way of helping the working poor. But our principal focus was early intervention in the poverty cycle by helping our children in poverty.

The two Presidents came to the conclusion of a need for an initiative here, even while we reduce the deficit, for a variety of reasons.

Children growing up in poverty are much more likely to grow up as poor adults with high rates of welfare, crime, drug abuse and dead-end jobs. At the same time the number of children at risk is growing, 1 in 5 today compared to 1 in 7, 20 years ago.

Our economy is going to need all the productive workers it can get over the next few decades, with low birth rates and increasingly complex skills required for this country to effectively compete in world markets, and yet, we will not be able to effectively compete if today's children are not well-educated and well-trained.

We cannot all progress together with increased standards of living, Mr. Chairman, if we have such a large pool of poorly trained and poorly educated people.

There is also abundant evidence which we found in our study that programs for poor children work and are cost-effective.

Presidents Ford and Carter noted the consequences of failing to intervene early with poor children, and costs we would all pay later in lost productivity, foregone taxes, increased prison and welfare costs.

They therefore strongly recommended an immediate, significant children's initiative, even as we reduce the deficit, with the goal over 8 years of fully covering all eligible children in Headstart, the WIC program, compensatory education, *prenatal care and immunizations*.

We estimated the additional cost in 1988 dollars of full eligibility at $9 to $13 billion, which spread over 8 years we felt was fully affordable.

The two Presidents recommended to President Bush that he should achieve that goal starting with an increase of $1 billion in fiscal 1990 for these worthwhile programs.

In short, we cannot afford not to make these investments.

The third issue in this committee's jurisdiction is the FSLIC crisis. Both Presidents, early on, recognized the problem that the savings and loan industry had, and the need, immediately, to deal with the staggering problem simply because of necessity.

This committee will have to be intimately involved because any reasonable option, including the one proposed yesterday by the President, will involve the issuance of bonds and methods to service the interest on them.

We spent more time on this one issue than any other save the budget deficit, meeting with a variety of experts including FDIC and Home Loan Bank Board staff.

Some 500 S&L's, almost 1 in 6, are insolvent, and another 400 are in such difficulty and so thinly capitalized that they are likely to fail.

FSLIC is short by what we estimated to be $50 to $100 billion and FSLIC is losing $1 billion a month. So that the longer we wait the higher the costs.

While there is currently no depositor panic, the longer we wait the more costly the solution, and a sharp rise in interest rates or a similar external shock could provoke a wholesale flight of depositors.

It is quite obvious that there is no painless or politically easy way to get out of this crisis. We recommended the following, which I may add is strikingly similar to the plan that we read about in the paper this morning from the Bush administration.

A reorganization of the regulation of the industry, with an administrative merger between FSLIC and FDIC under a regulatory board empowered to enforce uniform standards of accounting and capital for all commercial banks and S&L's.

The Bush package seems to suggest a similar administrative arrangement and common capital requirements, and we applaud that. It's very important, Mr. Chairman, to get FSLIC out from under the Home Loan Bank Board because of the implicit conflict of interest.

We also recommended closing within 2 years all insolvent S&L's which cannot meet these new capital requirements and raising up to $100 billion to pay off the depositors in failing S&L's. We examined a number of options to raise this huge sum with a minimum impact on the budget.

FSLIC has some assets remaining. We recommended that the special premium assessment on S&L's be kept and authority for bank holding companies to take over failing thrifts be developed, but even this will not be enough.

And therefore the two Presidents suggested several options to make up the difference including authorizing FSLIC to borrow enough money from the Treasury to pay off depositors, or to authorize the Bank Board, through the FICO mechanism, to issue up to $50 to $100 billion in long-term bonds backed by the full faith and credit of this country.

In the first option there is a huge budget exposure but perhaps less long-term costs. In the second, only the interest on the bonds would be absorbed by the Federal budget. It is the second option which the administration apparently has taken.

To make healthy S&L's pay for all of this would imperil them. To force banks to assume the burden of paying the interest exposure, was, in our estimation unfair, unless any bank fees went straight to the FDIC.

Your committee, Mr. Chairman, might also consider, as the two Presidents suggested, certain short-term in duration tax incentives to make the acquisition of a portfolio of bad real estate loans an attractive investment for firms specializing in real estate workouts.

But the two Presidents reluctantly came to the conclusion that some taxpayer involvement was inevitable. The sooner the political system comes to this conclusion the sooner we can get the S&L crisis behind us and deal with more important issues.

If I may conclude very briefly. Time does not permit a further explanation of all the other recommendations in this committee's broad jurisdiction.

I would only highlight, very, very briefly, two: trade and productivity. In the trade area the two Presidents recognized the degree to which other nations had caught up and, in some cases, passed this country in industry after industry.

Mr. Chairman, you and your committee gave the President new tools to help him reduce foreign barriers, and while both Presidents firmly rejected a protectionist policy as self-defeating and dangerous, they felt firm action in the trade area was warranted in the following ways.

A strong code of services, meaningful intellectual property protection, clear rules for U.S. foreign investment, a reduction in agricultural subsidies, and a strengthened GATT resolution procedure should result from the Uruguay round.

We also felt that under your new 1988 Trade Act, Mr. Chairman, the President should take a few early actions to establish the credibility of our trade policy by using the threat of retaliation in particularly blatant cases of unfair trade practices.

The two Presidents also felt we should work with the European Community to ensure that the creation of their single market in 1992 did not lead to further barriers to trade.

And last, the two Presidents stressed the need for a comprehensive package to deal with our lagging productivity. We cannot have increased real standards of living unless our productivity increases, and it has been dropping, precipitously, since the end of World War II.

This, we believe, must occur from more research and development. This country spends less per capita on civilian research and development than our major competitors who have lush tax incentives. R&D is inherently risky and the market alone does not provide an adequate incentive for U.S. companies to do all the R&D which is in our interests as a country to have them do.

Therefore, the two Presidents recommended that to stimulate additional research and development, that the R&D credit, and university basic research credit needed a long-term extension.

Mr. Cannon will now give some concluding remarks, Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. Cannon.

Mr. CANNON. Thank you, Mr. Chairman. Mr. Chairman, the testimony that Mr. Eizenstat has read is a joint statement to this committee by the two of us on behalf of the chairmen of the American Agenda, former President Ford, and former President Carter. I concur with what he has said.

In addition, Mr. Chairman, I would like to add a brief comment of my own. Some 18 years ago, Mr. Chairman, I had the opportunity to work with this committee, with the then-Chairman Wilbur Mills, and with members of Ways and Means on an important act of legislation, Federal revenue-sharing.

Out of that experience, Mr. Chairman, I came to have the highest regard and respect for this committee as an institution, and for its members. I still do.

At that earlier time I learned also that this committee has a unique link and responsibility to the Constitution, since the Constitution states, clearly, all bills for raising revenues shall originate in the House of Representatives, and since the House of Representatives created this committee, I believe some 200 years ago, to bear this revenue-raising responsibility along with other obligations.

So I came at that time, Mr. Chairman, to regard this committee, Ways and Means, as the fiscal conscience of the Nation.

In my judgment, this committee has the hardest task in Congress, and that is to strike some balance between the Federal Government's responsibilities to meet the needs of the American people, and the American taxpayers' reluctance to pay for those needs.

In that sense, Mr. Chairman, this is a committee that stands in the front line of democratic government. Year after year, you face reality, every year, every session.

Facing reality became the theme of the American Agenda in this report by President Ford, President Carter, and all the other distinguished private citizens who took part.

Out of our bipartisan initiative came one conclusion that is inescapable. The Federal deficit is not the fault of any particular President, nor is it the fault of either political party nor of Congress.

The more profound problem, in my judgment, is that the American people have come to expect more from the Federal Government than they are willing to pay for.

In our report, we tried, as best we could, to share this conclusion with the new administration, and with anyone else who would listen, to say it is time to face the reality that deficits are hurting the country.

It is human nature to oppose cutting Government benefits or raising Federal taxes, but our studies over the last year convinced us that the majority of Americans understood that something must be done to reduce the Federal deficit, and the two former Presidents, and others in the American Agenda project, believe that a fair, balanced, and realistic plan to reduce the deficit would command national support if advocated by both the new President and the new Congress.

Thank you, Mr. Chairman, and members, for giving Mr. Eizenstat and me the opportunity to appear before your committee.

[The statement of Messrs. Eizenstat and Cannon follows:]

TESTIMONY BY STUART E. EIZENSTAT AND JAMES M. CANNON
CO-DIRECTORS, THE AMERICAN AGENDA AND
FORMER CHIEF DOMESTIC POLICY ADVISERS TO PRESIDENTS
JIMMY CARTER AND GERALD R. FORD

Mr. Chairman and Members of the Committee, we appreciate the opportunity to appear before you to discuss the American Agenda report, with particular emphasis on those issues which come within this Committee's broad jurisdiction.

We conceived and organized the American Agenda, with a grant from the Times Mirror Company, one year ago as a bipartisan organization, under the Chairmanship of former Presidents Jimmy Carter and Gerald R. Ford, with several purposes in mind. First, we believed that presidential campaigns, by their very nature, rarely involve discussion in any detail of many of the critical issues the winning candidate must address as President of the United States. In this we were certainly not disappointed by the substance of the 1988 presidential campaign. It was our conviction that if a group of experienced former top government officials could identify the key issues a new President would likely have to face early in his term, it would help him and his staff more promptly get on top of them, and avoid stepping on the land mine issues lurking after January 20.

We also believed that transition periods between a hectic election and Inauguration Day were vastly underrated. The transition is not a time for rest, relaxation, and celebration--before the real business of governing begins. In point of fact, the transition is a critical decisionmaking time, which can have a great influence on the success of a presidency. It is during this time that the key appointments are made of people in whose hands the fate of the next President will heavily rest. A budget must be put together to supplant or amend the one put together by the outgoing President. Key legislative priorities must be determined from among the myriad campaign promises. Having been involved in transitions, we felt we could offer pointed advice on how to productively use the transition period and could emphasize its importance to the new President-elect and his staff. A good transition would help guarantee a fast start for the new President when he began to govern. Stu Eizenstat recalled how the failure of the Carter transition to quickly organize and develop a clear set of legislative priorities contributed to the difficult first year of the Administration's relations with Congress.

A third objective was, for the first time, to make effective use of the wisdom and experience of two former Presidents--what they had learned from their failures as well as their successes--for the benefit of the next President. In parliamentary systems, former prime ministers normally stay in their Parliaments and continue to have a voice in policy. We relegate our former Chief Executives to the political equivalent of the elephant burial ground, never to be heard from again. We believed Presidents Carter and Ford had something to say about the challenges facing the nation and the 41st President of the United States.

Last, we believed--and our beliefs were confirmed even beyond our expectations--that there were many areas of bipartisan convergence on the major domestic, foreign policy, and defense issues of the day, which would be masked by an inevitably polarizing and divisive presidential campaign. By illuminating those areas of bipartisan agreement we could make it somewhat easier for the new President to develop a bipartisan consensus with Congress to solve some of our country's most pressing problems, to rally public support, and to govern efficiently.

To assist us in achieving those purposes, we were able to enlist, with the direct help of Presidents Carter and Ford, a distinguished Executive Committee of eight prominent Democrats and eight prominent Republicans, each of whom had a senior position in Congress, the Executive Branch, the corporate world, unions, or the voluntary sector. This was a working Executive Committee, not a show Committee. We were assisted by an able staff and by five Senior Policy Coordinators who had themselves held senior positions in government and the private sector.

We divided our task into five panels, each co-chaired by a Democrat and a Republican on the Executive Committee, covering economic policy, domestic policy, foreign policy, defense and arms control, and presidential decisionmaking. Over the better part of a year, these panels convened meetings of experts from around the country and commissioned papers from dozens of the best minds in the country. Over 320 outside people, including a number of Members of Congress, participated in the work of the American Agenda.

In addition, the two of us worked very closely with the staff of the National Economic Commission, the General Accounting Office, the Congressional Office of Technology Assessment, and many other public and private organizations.

Each of the five panels, with our assistance, selected their own priorities and drafted their own report. In turn, the two Presidents selected six priority issues for suggested immediate action by the new President in the early weeks and months of his Administration, and another six which Presidents Carter and Ford felt were presidential level priorities that would require his continuing attention throughout his term, but did not require such immediate attention. In the category for immediate action were the need for deficit reduction; suggestions for early decision in the arms control, defense budget, and defense management areas; prompt solution to the savings and loan crisis; recommendations on trade and the need for Third World debt relief; attacking the growing problem of children in poverty, or as we called it, children at risk; and concrete suggestions to bolster relations with our allies. In the longer-term category were the following six issues: productivity and competitiveness; U.S.-Soviet relations; relations with Mexico, Nicaragua and Central America; the global environmental problems; and drugs. This report was presented personally to President-elect Bush and key members of his transition team and we met with Mr. Bush to discuss it.

Mr. Chairman, permit us to focus on several of the recommendations in which this Committee might be most interested.

I. The Budget Deficit

It was a common consensus of the two Presidents and of the Executive Committee that reducing the budget deficit and balancing the unified Federal budget by the mid-1990's was the single most important issue facing the next Administration, foreign or domestic.

If the deficit could not be successfully tackled, little else could be accomplished. Without substantial deficit reduction it was felt we would not have an economy strong enough to increase our living standard and that of our children; to produce the revenues necessary for vital domestic needs and to sustain our defenses; to allow us to project our leadership in foreign and international economic policy.

Our deficit was a symbol of our own inability as a nation to match our demands on government with a willingness to pay for them.

The two Presidents, each of whom had struggled with the deficit, were horrified at Federal deficits in the past several years three and four times higher than they had ever had during their terms. They saw the accumulated debt of $2.8 trillion, mounting at a rate of $12 billion a month, as stealing increasingly large amounts of hard-earned taxpayers' dollars which could have been used for productive purposes. More and more is going simply to service the deficit--now one in every seven budget dollars.

They believed the large deficits were a principal cause of our unacceptably high trade deficits. And they saw the deficits as leading to a loss of control over our own economic futures, because increasingly the U.S. is financing its Federal deficit not from our own domestic savings pool, which has declined precipitously, but from foreign investors. If these foreign interests lost confidence in our economic management, they could produce a recession in our country.

The two Presidents examined three budget reduction options prepared by the co-chairs of our Economic Panel, Alice Rivlin and Paul O'Neill, both budget experts. All were based on fairly optimistic economic assumptions of moderate real growth in GNP, moderate inflation, and gradually falling interest rates.

One option was similar to Mr. Bush's freeze option and looked at what measures would be necessary if there were no tax increases, no Social Security cuts, and no real reductions in defense spending. President Carter rejected this option as politically unrealistic over a four-year period and as substantively unwise. It would require holding discretionary domestic spending at 1988 dollar levels for five years, cutting Medicaid and Medicare by 20 percent from projected levels, foregoing cost-of-living adjustments for Federal workers and retirees for five years beginning in FY 1989--and we would still be $40 billion short of the Gramm-Rudman-Hollings target of zero deficit by 1993. This option means taking disproportionate cuts in the small slice of the budget made up of discretionary domestic spending which has borne such a heavy burden over the past eight years. This option left no room for needed domestic investments which the two Presidents recommended in the American Agenda report.

Another option produced by the Economic Panel had large tax increases, a one percent real increase in defense spending, some domestic cuts and, by FY 1993, $20 billion in spending for productivity enhancing programs. The heart of this proposal was a five percent Value Added Tax with exceptions to correct for regressiveness. By FY 1993 such a VAT would raise over $73 billion annually. In addition, a gasoline tax rising to 20 cents per gallon was part of the option, and a doubling of the cigarette tax from 16 cents to 32 cents per pack (before the tax per pack of tobacco excise taxes had been indexed to inflation in 1951), together with increasing the tax rate on beer (16 cents to 63 cents) and wine (3 cents to 54 cents) to the alcohol equivalent of distilled spirits.

President Carter and President Ford likewise did not accept this option. They felt the large tax increases were unachievable and undesirable in their potential impact on the economy. They also felt a VAT required a great deal of additional study before anyone could confidently recommend it.

A third option proposed a one percent real cut in defense combined with $50 billion in domestic cuts, from Medicare to a variety of subsidies, and moderate taxes. The taxes consisted of a cigarette and alcohol tax increase, a 20-cent gasoline tax, and a tax on 85 percent of Social Security benefits.

Presidents Carter and Ford developed their own option, based on the need for both deficit reductions and additional spending in selected areas of the domestic investment program, particularly for poor young children, and a productivity package. It was based on the following major components:

-- holding the line on defense spending to inflation only, with no real growth in defense;

-- a 2 percent reduction in the cost-of-living adjustment for Social Security and Federal retirement beneficiaries, which together would save about $30 billion by 1993;

-- a Medicare cap on fees for physicians, which saves $10 billion from the CBO baseline deficit by 1993;

-- a five pecent reduction in agricultural target prices, for a $2 billion saving;

-- a variety of reductions in lower priority domestic programs, like Amtrak subsidies and the Economic Development Administration; and

-- consumption taxes, consisting of a 6-cent rise in the motor fuel tax on gas and diesel, a doubling of the cigarette tax per pack, and a rise in beer and wine taxes.

The two Presidents were also willing to positively consider additional deficit reduction measures, if needed, such as taxing 85 percent of Social Security benefits.

We recognized that with rosy enough economic assumptions it was possible to achieve the $100 billion Gramm-Rudman-Hollings target of FY 1990 without tax increases. But these targets could not be reached realistically over four years without taxes. And even in FY 1990, revenue increases would be needed to make the additional investments in education, the environment, job training, and research and development which were desirable, let alone meet the short-term crisis of FSLIC.

Presidents Ford and Carter believed that the consumption taxes they recommended had multiple benefits. They would reduce the deficit, provide some of the revenues needed for our pressing domestic needs, and reduce the consumption of items that neither contributed to the health of individual Americans or to the nation as a whole.

II. Children at Risk

The two Presidents and American Agenda's Domestic Panel, co-chaired by former Senator Edmund Muskie and Carla Hills (now the United States Special Trade Representative) were moved by the compelling facts presented by a variety of experts of varying ideologies about the continued high level of poverty in the U.S., particularly among children, despite six years of economic recovery, and the implications for the future of our country. In fact, income equalities have been aggravated over the past ten years, with both wealth and poverty up.

The figures were stark. Thirty-three million Americans--14 percent of our population--are in poverty. Thirteen million of them are children. In the U.S. today one child in five is poor, a staggering figure for the world's richest nation.

About one-third of the poor are elderly and disabled. Another third is temporarily poor due to a loss of job or some other misfortune. And the last third live in households that are chronically poor even though the head of household is neither elderly nor poor.

Mr. Chairman, we convened many of the leading experts in the field and they told us that there are no clear answers to deal with the chronically poor. We applaud the historic step, Mr. Chairman, you and your Committee took last year in the welfare reform act, which will hopefully be one piece of the puzzle. But these experts urged us to focus on two groups where there were clearer solutions which would work: children at risk and the working poor.

Our Domestic Panel suggested a variety of options which could genuinely help the working poor. Some 47 percent of poor households are headed by someone who works at least part of the year and 15 percent by someone who works full-time for the entire year but remains poor. The working poor deserved help to keep them off welfare and away from crime. Our options included an increase in the minimum wage and, in your Committee's jurisdiction, a more targeted and less inflationary approach: a more generous Earned Income Tax Credit varied by family size.

But our principal focus and the area Presidents Ford and Carter recommended for attention by the next President was early intervention in the poverty cycle by helping our children in poverty. They came to this conclusion for a variety of reasons:

o Children growing up in poverty are much more likely to grow up as poor adults, with higher rates of welfare and crime, drug abuse, and dead-end jobs.

o The number of children at risk is growing, with one in five poor today compared to one in seven in 1969.

o Our economy is going to need all the productive workers it can get in the next five decades, with low birth rates and increasingly complex skills required for the U.S. to effectively compete in world markets. We will not be able to do so if today's children are not well educated and well trained.

o There is abundant evidence that programs for poor children work and are cost-effective. Independent studies demonstrated that $1 invested in prenatal care would save $3.38 in the cost of care for low birth weight infants. Similarly, $1 invested in preschool education saved almost $5 in lower costs for special education, public assistance, and crime.

Presidents Ford and Carter noted the consequences of failing to intervene early with poor children in costs we will all pay later. Each year's high school dropout class costs the U.S. $34 billion in lost productivity and foregone taxes. It costs us $6 billion a year to maintain our prison population and $17 billion to support teenage mothers and their children. We know early childhood programs work but they fail to cover all eligible children.

The Presidents strongly recommended an immediate, significant children's initiative, even as we reduce the deficit, with the goal of fully covering all eligible children within eight years in Head Start, WIC, Compensatory Education, prenatal care, and immunizations. We estimate this can be accomplished for an additional $9 to $13 billion in 1988 dollars, an affordable investment spread over the next eight years. Presidents Ford and Carter recommended to President Bush he begin to achieve that goal by an increase of $1 billion in the FY 1990 budget for these worthwhile programs. We cannot afford not to make these investments in our children.

We sense a bipartisan interest in the Congress in helping our poor children. We hope this Committee will take the lead.

III. The Savings and Loan Crisis

Presidents Ford and Carter recommended that the new President immediately and forcefully deal with the staggering savings and loan problem, not because he or the Congress would choose this as a priority area, but because of sheer necessity. This Committee will have to be intimately involved because any reasonable option will involve the issuance of bonds and methods to service the interest on them.

Mr. Chairman, we spent more time on this issue than any single issue, save the budget deficit. We met on several occasions with William Seidman and his staff at the Federal Deposit Insurance Corporation and with Danny Wall at the Federal Home Loan Bank Board.

Some 500 savings and loan associations--almost one in every six--are insolvent by generally accepted accounting principles and another 400 are in such difficulty and so thinly capitalized they are likely to fail. FSLIC, the insurance bureau of the Bank Board, is short by what we estimated was $50 to $100 billion (insured deposit liabilities exceed the market value of assets). That is the amount needed to pay off the depositors of the S&L's that are insolvent but still operating and still losing money. FSLIC is losing $1 billion per month.

S&L's and FSLIC which insures them got into their financial difficulty for a variety of reasons--deregulation in the early 1980's; soaring interest rates; the collapse of high priced real estate and energy markets in the Southwest; inadequate capital and accounting standards; and insufficient oversight by the Federal Home Loan Bank Board.

To compound matters, rather than promptly closing insolvent S&L's, the Federal Home Loan Bank Board encouraged them to grow their way out of their problems, leading them to offer still higher interest rates to depositors, to make riskier loans, and, eventually, to go deeper in debt.

While there is currently no depositor panic due to the public's faith in the deposit insurance system, the longer we wait the more costly the solution. And a sharp rise in interest rates or a similar external shock could provoke a wholesale flight of depositors. Moreover, the failing thrifts are threatening the healthy ones by bidding up the cost of funds.

Mr. Chairman and Members of the Committee, there is no painless or politically easy way to get out of this crisis. Presidents Ford and Carter recommended:

o A reorganization of the regulation of the industry, with an administrative merger between FSLIC and FDIC under a regulatory board empowered to enforce uniform standards of accounting and capital standards for all commercial banks and S&L's.

o Closing, within two years, all insolvent S&L's which cannot meet capital requirements.

o Raising up to $100 billion to pay off the depositors in the S&L's which will be unable to meet these standards.

We examined a number of options to raise this huge sum with a minimum of impact on the Federal budget.

FSLIC has some assets remaining, the special premium assessment on S&L's should be kept, incentives for bank holding companies to take over failing thrifts should be developed, but this will not be enough. The Presidents suggested several options to make up the difference, including authorizing FSLIC to borrow enough money from the Treasury to pay off the depositors or authorize the Home Loan Bank Board, through the existing FICO mechanism, to issue up to $50 to $100 billion in long-term bonds backed by the full faith and credit of the United States. In the first option, there is a huge budget exposure. In the second, only the interest on the bonds would be absorbed by the Federal budget. The proceeds from the bonds would be contributed by FICO to FSLIC.

To make healthy S&L's pay for this would imperil them and to force banks to assume the burden is unfair.

The Committee might also consider, as the two Presidents suggested, providing tax incentives to make the acquisition of a portfolio of bad real estate loans an attractive investment for firms specializing in real estate workouts.

But Presidents Ford and Carter reluctantly came to the conclusion that some taxpayer involvement was inevitable. The sooner the political system comes to this conclusion, the sooner we can get the S&L crisis behind us and deal with more important issues.

IV. Other Issues

There are a variety of other recommendations in the American Agenda report which are squarely within this Committee's jurisdiction. While time does not permit a full discussion of these, we would briefly highlight two--trade and productivity through increased research and development.

In the trade area, the two Presidents recognized the degree to which other nations have caught up and, in some cases, passed the U.S. In 1950, we produced 33 percent of the world's GNP, today only 26 percent and declining. We are importing $130 billion more than we are exporting in part due to foreign barriers to U.S. exports and in part due to our own lack of competitiveness.

Fifteen years ago American companies made 95 percent of the telephones and 80 percent of the TV sets in American homes. Today, American companies make only one in four telephones and one in ten TV sets sold in the U.S. Our share of world automotive output declined from 52 percent in 1960 to 23 percent in the 1980's. In the same period, our share of world steel production declined from 26 percent to 11 percent.

Mr. Chairman, you and your Committee gave the President new tools to help the President reduce foreign barriers. Both Presidents firmly rejected a protectionist policy which is self-defeating and dangerous in our interdependent world economy. But they felt strong action in the trade area was warranted in the following ways:

o A strong code of services, meaningful intellectual property protection, clear rules for U.S. foreign investment abroad, a reduction in agricultural subsidies, and a strengthened GATT resolution procedure should result from the Uruguay Round.

o The President should take a few early actions under the new 1988 Trade Act to establish the credibility of American fair trade policy by using the threat of retaliation in particularly blatant cases of unfair trade practices.

- We should work with the European Community to assure that the creation of their Single Market in 1992 does not lead to further barriers to U.S. trade.

- A ministerial level forum should be created with Japan which will lead to a comprehensive approach to anticipate and head off troublesome issues and to avoid frequent confrontations with Japan over trade at a time when we need their financial resources to help with Third World economic development and debt relief.

Presidents Ford and Carter also stressed the need for a comprehensive approach to deal with the lagging productivity in the U.S. Productivity increases have dropped precipitously in each decade since the end of World War II. Yet productivity is the key to staying at the cutting edge of change. This must occur from research and development. But the U.S. spends less per capita on civilian R&D than our major trade competitors who have lush tax incentives for research. R&D is inherently risky and the market alone does not provide an adequate incentive for U.S. companies to do all the R&D which is in America's interest to have them do. To encourage R&D--and the jobs which follow it--to stay in the U.S., to compete with foreign incentives, and to stimulate additional R&D in America, the two Presidents concluded that the R&D tax credit and university research credit needed to have a long-term extension. The short-term extension since 1981 and the reduction in the value of the credit do not provide the certainty American industry needs.

We appreciate the opportunity to summarize some of the suggestions of the American Agenda report and will be pleased to answer any questions you may have.

* * * * *

Chairman ROSTENKOWSKI. To both of you, your testimony outlines proposals to aid insolvent thrift institutions. Yesterday, as you well know, President Bush unveiled a program to assist these institutions.

Are you familiar with those broad outlines that the President proposed, and, if so, how do they relate to the suggestions that you have made in your testimony, Mr. Eizenstat?

Mr. EIZENSTAT. Mr. Chairman, they are really strikingly similar in a number of respects. First, they suggest an administrative merger of the FDIC and FSLIC, in which the FDIC will, in essence, administratively oversee both the S&L and the commercial banking industry.

In addition, they suggest, as did we, that it was important that FSLIC, the insurance division of the Home Loan Bank Board, be pulled out from under the Home Loan Bank Board because the Home Loan Bank Board really has a conflict of interest.

It is, on the one hand, a promoter of the industry. It is an advocate for the industry. On the other hand, it has got to insure it. And we thought that by separating those two functions that conflict would be ended.

Third, it does rely on the issuance of bonds, as we had proposed, and it puts the interest on the budget. There are a couple of points, however, if I may, Mr. Chairman, just as a cautionary note.

One is that I think it is very important to be sure that the additional premium on the S&L industry, which we did not recommend per se, be done in a way that does not sink the healthy institutions or the marginal institutions, and end up adding additional costs which we will have to pick up later.

And likewise, that if there is to be an additional fee on commercial who had no role in creating this problem, that those moneys, Mr. Chairman, go into the FDIC fund and not to bail out the S&L's.

In addition, it is very important, we think—since your committee will undoubtedly be looking at the issuance of the bonds—to make sure that there is enough cash to service the $7 to $9 billion interest debt, and since there are not enough details at this point to know, I think this committee needs to look very, very closely to be sure that the cash flow is sufficient to meet those interest costs.

But in broad perspective, we think that this is a good proposal, it does follow, in broad terms, the suggestions we made, and it is a recognition that the longer we wait the higher the costs of a bailout will be.

Chairman ROSTENKOWSKI. Mr. Cannon.

Mr. CANNON. Mr. Chairman, one addition to that. I agree with what Stu has said. Substantively, the plan is very good. In addition, I think this is an important—I commend the President for doing this. Less than 3 weeks after he took office he has faced this problem squarely, honestly, thoroughly, and I think that his proposal meets the test of the words that you used in your opening remarks.

I think that it meets the problem justly, fairly, and honestly, and I think that, all by itself, is a very encouraging sign for this new administration, and for the years ahead.

Mr. EIZENSTAT. Mr. Chairman, if I may just add one other point on this. In terms of this additional fee that is going to be imposed on the S&L industry and on the banks, I think it is very important that we look at it also from a competitiveness issue.

I have already mentioned the concern that too great an increase in the premiums on top of the special premiums the S&L industry is already facing may imperil some of the healthy institutions.

There is also a problem with the $1.5 billion additional fee that the commercial banks are expected to pay. They are already at a competitive disadvantage when compared to foreign banks that have expanded powers that U.S. banks cannot have under the Glass-Stiegel restrictions, and I think it is important that this additional fee not make them further uncompetitive with respect to foreign banks and their mutual fund competitors.

Chairman ROSTENKOWSKI. Mr. Eizenstat and Mr. Cannon, I am concerned, naturally, with just what the entire industry thinks and what their position will be. We, here, on this committee, as you well know, went through a period of time when we recommended that we withhold on interest and dividends paid by the thrift institutions, and of course we enacted the law and then repealed it.

I am concerned, really, with whether the healthy institutions are going to back this proposal. If there is a division in the industry, that will make it much more difficult for us because of the letter-writing and the postcard campaigns that go on in the industry.

I am just hoping that the industry comes behind a proposal—it might be the President's—and that we can fight this problem in a united way.

Mr. EIZENSTAT. Well, in the process of coming up with our recommendations we did meet with members of the industry, and the industry is divided basically between the healthy and the unhealthy ones, and quite frankly, the healthy ones, some were even considering leaving and going under the FDIC as they have the option to do.

My guess is that while there will be concerns about the additional fee on the S&L industry, that they recognize that there has been a fair effort to apportion, broadly, the costs of this, and that there can only be a program which would be even more onerous for them if something like this is not accepted.

So I am hoping that you will not get that kind of united opposition. My guess is that you will not, but that you will be hearing from the healthier institutions saying to mitigate the increase in the fees, that we may be able to pay some but not as much as the administration suggests.

Chairman ROSTENKOWSKI. Do you have—with respect to balancing the unified Federal budget by 1990—do you have any level that you could recommend at which tax increases would be necessary?

Has there been any discussion as to what level we in this committee have to raise taxes or at least raise revenue?

Mr. EIZENSTAT. In our proposal, our consumption taxes—taking the fuel taxes, the cigarette taxes, and the beer and wine taxes together—are about $13 billion per year, each year, from fiscal 1990 through fiscal 1993.

That can be varied up or down. For example, the two Presidents were willing to have an 85 percent tax on Social Security benefits. It is now 50 percent. That raises another $4 billion a year. That would give you somewhere around $17 billion a year, if necessary.

But the figures we have in our actual plan are about $13 billion each year. Six billion from a 6-cent increase in the motor fuel tax; $3 billion from a doubling of the cigarette tax; and $4 billion from raising beer and wine taxes to their alcohol equivalent.

Mr. CANNON. An additional point on that, Mr. Chairman.

President Ford who was centrally involved in the creation of this plan—it was not something handed to him, this was a plan that he and President Carter worked out between them—we recommended, or I recommended, I should say, a much higher gasoline tax, and I felt that this country can sustain it. We pay still, the lowest by far, gasoline prices in the world, and taxes would have both the benefit of raising money and decreasing consumption of gasoline.

President Ford felt strongly that 6 cents per gallon is about as far as you could go, realistically, because while it sounds easy to a lot of people who live in the cities, to people who live in the West, and the outlying parts of the country, it going to be very difficult for them to pay another 25 cents for a gallon of gasoline because so many of their lives and livelihood depend on having the car and using the car.

So 6 cents a gallon was as far as President Ford could go on it.

Chairman ROSTENKOWSKI. I agree with President Ford. However, I would like the industry, the industrial giants that created the automobile, to start looking at fuel injection and finding out whether or not they can get more miles to the gallon.

It seems as though our competitors overseas are finding fuel efficiency and we are neglecting to become responsible in that area.

I would just like to conclude with a suggestion that you may carry back to your principals. I am sure that the entire committee joins me in this.

At any time that they are in town and they would like an informal or a formal meeting, a casual get-together, where we could discuss issues with either President Ford or President Carter, I am sure that many members of this committee would find that very much worthwhile. Mr. Archer.

Mr. ARCHER. Thank you, Mr. Chairman.

I had a statement that I would like, with your permission, to have included in the record.

Chairman ROSTENKOWSKI. Without objection.

[The statement of Mr. Archer follows:]

OPENING STATEMENT OF THE HONORABLE BILL ARCHER
FEBRUARY 7, 1989

THANK YOU MR. CHAIRMAN,

LET ME BEGIN BY THANKING CHAIRMAN ROSTENKOWSKI FOR CALLING THESE HEARINGS ON THE IMPORTANT SUBJECT OF FEDERAL DEFICIT REDUCTION. I WANT TO JOIN WITH HIM IN WELCOMING THE WITNESSES WHO WILL BE APPEARING BEFORE US. I KNOW THAT ALL OF US LOOK FORWARD TO THEIR TESTIMONY.

I AM PARTICULARLY PLEASED ABOUT THE BROAD NATURE OF THESE HEARINGS. THAT WILL GIVE US AN OPPORTUNITY TO DISCUSS THE ISSUE OF FEDERAL FISCAL POLICY -- AND RELATED ISSUES -- FROM A VARIETY OF PERSPECTIVES.

AS WE EXPLORE THE "NUTS AND BOLTS" OF DEFICIT REDUCTION, WE MUST ALSO CONSIDER THE IMPACT OF POTENTIAL CHOICES ON THE STANDARD OF LIVING WE EXPECT AMERICANS TO BE ABLE TO ENJOY IN THE YEARS TO COME. WE NEED TO EXAMINE THE CONSEQUENCES OF THE FEDERAL GOVERNMENT CONTINUING TO CONSUME A DISPROPORTIONATE SHARE OF THE NATION'S WEALTH -- AND WHAT THAT MEANS IN TERMS OF THE FUTURE PROSPERITY OF OUR CITIZENS.

WE NEED TO REMIND OURSELVES CONTINUALLY THAT OUR FISCAL POLICY DECISIONS REALLY COME DOWN TO PRACTICAL DECISIONS WHICH AFFECT INDIVIDUAL AMERICANS -- AND NOT JUST SOME MACRO-ECONOMIC MODEL DEVOID OF FLESH AND BONE.

THE FEDERAL BUDGET IS ONE ELEMENT OF ECONOMIC POLICY THAT IS DIRECTLY AND SOLEY THE RESPONSIBILITY OF THE PRESIDENT AND THE CONGRESS. YOU WOULD THINK THAT OVER THE YEARS WE WOULD HAVE LEARNED TO PERFORM OUR BUDGETARY TASK WELL. IN REALITY, WE HAVE NOT.

AS WE START THESE IMPORTANT HEARINGS, IT MIGHT BE USEFUL TO CONSIDER FOR A MOMENT WHERE WE WOULD BE TODAY IF WE HAD STUCK TO THE ORIGINAL GRAMM-RUDMAN TARGETS.

OUR FISCAL YEAR 1989 DEFICIT WOULD BE $72 BILLION DOLLARS -- AND WE WOULD BE SHOOTING FOR A TARGET THIS YEAR OF $36 BILLION. OUR DEFICIT AS A PERCENTAGE OF GROSS NATIONAL PRODUCT WOULD BE AROUND ONE PERCENT. INTEREST RATES WOULD BE LOWER -- AND THE FINANCIAL MARKETS AND OUR TRADING PARTNERS MUCH RELIEVED.

THIS TIME, LET US TAKE THE OPPORTUNITY TO COMPLETE THE TASK OF ESTABLISHING THE BLUEPRINT FOR ELIMINATION OF THE FEDERAL DEFICIT. I KNOW THAT PRESIDENT BUSH IS ANXIOUS TO ROLL UP HIS SLEEVES AND WORK WITH US.

LATER THIS WEEK, WE'LL HEAR MORE SPECIFICALLY ABOUT THE APPROACH HE IS RECOMMENDING -- BUT I BELIEVE IT IS CLEAR ALREADY THAT HE DOES NOT BELIEVE THAT THE PRESCRIPTION IS HIGHER TAXES. I FOR ONE SHARE THAT BELIEF -- AND WOULD HOPE THAT THE MAJORITY ON THIS COMMITTEE AND IN THE HOUSE OF REPRESENTATIVES NOT DECLARE HIS BUDGET "DEAD ON ARRIVAL" SIMPLY BECAUSE IT MAY NOT FIT THEIR OWN PRECONCEIVED NOTION THAT DEFICIT REDUCTION BY DEFINITION MEANS A TAX INCREASE.

THIS COMMITTEE WILL BE 200 YEARS OLD IN JULY. WHEN THE WAYS AND MEANS COMMITTEE BEGAN, THE WORLD . . . AND SOMETIMES THE NATION ITSELF . . . EXPRESSED SKEPTICISM ABOUT THE ABILITY OF THE NEW AMERICAN CONGRESS TO FINANCE THE NATION'S GOVERNMENTAL NEEDS. THEY LEARNED THAT IT COULD . . . AND WOULD.

TWO HUNDRED YEARS LATER, WE ARE STILL GRAPPLING WITH HOW WE DEFINE THOSE NECESSARY GOVERNMENT SERVICES . . . AND THE WAYS AND MEANS TO PAY FOR THEM.

THANK YOU, MR. CHAIRMAN. I LOOK FORWARD TO HEARING FROM OUR WITNESSES.

Mr. Archer. And I would just excerpt a little bit from it. First, I want to thank you gentlemen for a very constructive and thoughtful presentation to our committee.

We might note at this time, that had we stuck to the original Gramm-Rudman targets, that our fiscal deficit for 1989 would be $72 billion, and that we would be shooting for a target this year of $36 billion for the fiscal year 1990.

Our deficit as a percent of gross national product would be about 1 percent, and interest rates would be lower in the financial markets and our trading partners would be relieved.

I hope that we will have the courage to at least meet the reduced targets for this year. I believe that President Bush is ready to roll up his sleeves and work with us, and I hope that we will be receptive to what he presents to us later this week and react not as we have in the past, to declare this recommendation dead on arrival just because it does not include any new taxes.

I would like to inquire of you, if I may, about one aspect of your recommendation which concerns me a great deal.

My own view is that the future of this country and its standard of living is going to depend on our ability to save and have capital formation and job creation.

I am very concerned about your urging or being willing to accept an increase in the taxation of Social Security benefits, for the reason that, as I understand your proposal, it would build on the current law. The only people who have their Social Security benefits taxed under current law are those who have saved and provided for their own retirement, and have taxable income at the time of retirement.

If you continue to urge further taxation of Social Security benefits, and continue the process that the Congress used in the catastrophic illness program, of further taxing earnings of the elderly after they have retired with a special income tax rate, you are most surely going to create a disincentive for savings during the worklife of workers.

Unions will find that there is no incentive to negotiate union pension plans because their workers are going to have more and more of it taken away from them after they retire.

Why do that? Just take it up front and spend it, and become wards of the Government. There will be a disincentive to Keogh plans, company pension plans, IRA's, are any personal savings, that they are going to look forward to at a time when they retire, because they are going to have to pay a bigger and bigger tax.

I am curious as to how you would respond to that because I think it is going to have a negative impact on the savings structure of this country.

Mr. Eizenstat. Mr. Archer, first, in our basic plan, we do not recommend that. It is not in our budget chart, and we reach our savings without an 85 percent tax. Two Presidents indicated that they felt if, as a last resort, one still could not achieve budget balance over a 5-year period, that this would be an area to look at.

We are already taxing 50 percent. It essentially only impacts upper-income taxpayers. The most important thing we can do in terms of national savings is to reduce the deficit, and to reduce the demand on the already small savings pool that the Federal Government is placing.

That would be a more important way of inducing national savings. So, it was a combination of building on the 50 percent tax that is already there, using it as a last resort if we cannot achieve reduction by the means that we recommended, which did not include that, suggestion.

Mr. ARCHER. Well, I understand that you say it is a last resort, but sometimes last resorts become first resorts when the Congress gets ahold of them. I just wanted to express my own disappointment that you have, in any way, certified that as a possible answer to our deficit problems, because I submit to you, that I think in the long pull, you will lose far more in incentive for savings from the working population than you will gain in this deficit reduction of this $4 billion.

Could I ask you whether you looked at the question of the earnings test and the negative impact that that has under Social Security on the working public?

Mr. EIZENSTAT. No, sir. We did not.

Mr. ARCHER. So you have no recommendation for us on that?

Mr. EIZENSTAT. No.

Mr. ARCHER. Thank you.

Chairman ROSTENKOWSKI. Mr. Jacobs will inquire.

Mr. JACOBS. First of all, I wanted to say to Mr. Cannon, that candid thing you said a moment ago about the public wanting more services than they are willing to pay for, I am sad to say, has ample evidence to support itself.

When de Toqueville wrote about democracy in America in the early part of the last century, he said the crunch would come—reading the fate of his own country in the late 18th century—precisely when we became an urban society and our affairs became complicated, and, in essence, when the Government machinery became complicated enough for unworthy people to use it to hit the jackpot for themselves at the expense of others.

The expense of that, in the last part of the 18th century, in France, was that for 40 years the economy was devastated—wrecked. By the end of that last decade it is said that people lined up, or queued up for public bread lines that required almost 12 hours, and that gave rise to the famous statement, "Let them eat cake," which was generally misunderstood because cake was not a confection but the liner in the bread oven.

The point is that history does tend to repeat itself, and it is staggering to note that no matter what the society is, a group of people usually, sooner or later, manages to fool itself or be fooled into the notion that there is a substitute from ordinary work.

Having said that, and being maybe not entirely popular around here for having begun the so-called balanced budget amendment movement.

I now ask you: Can you imagine any greater restraint on excessive public spending than an iron-clad requirement that it be matched with public taxation from the point of view of the public officials?

Mr. CANNON. I do not, Mr. Chairman. I would support that enthusiastically. I believe budgets ought to be in balance, and the

Federal budgets, State budgets—I believe it is not constructive to suggest to people that it can be otherwise.

We read in the press now and then that deficits do not matter, that is false. I think deficits do matter.

Mr. JACOBS. I have a notion, although it is inspired by my father who said it at the time, that if Lyndon Johnson and Richard Nixon had asked for the taxes to pay for the Vietnam war while it was going on, rather than making it a credit-card war, that it would have stopped two things: first, the inflation, and, second, the war, if people had realized how much it would cost them individually, and it is costing them now, of course, with interest on the additional debt, which I reckon to be about $400 billion.

I wanted to ask, too, about what we read about the administration's possible solution for the S&L problems.

As I understood it they recommended some bonding in order to raise money. Is that correct? Did I have that right?

Mr. EIZENSTAT. Yes, Mr. Jacobs.

Mr. JACOBS. Well, now tell me this, just in terms of old-fashioned prudence: how much sense does it make to solve a problem of overborrowing—which obviously the S&L problem is—by borrowing still further, borrowing yourself out of the problem of borrowing? Explain to me why that makes sense. Or does it to you?

Mr. EIZENSTAT. Well, the problem with the S&L industry is multifold. It involves a lack of appropriate oversight and regulation, in some cases fraudulent loans, in other cases negligently made loans, a dramatic drop in energy prices which depressed the value of the collateral which they had——

Mr. JACOBS. Which all adds up to overborrowing.

Mr. EIZENSTAT. But there is no simple solution to it. We have got, right now, a Federal guarantee under all of that. FDIC, under the banks, and FSLIC, under the savings and loans, they would have to pay it off, and the question is how do you raise the money. FSLIC does not have the money to pay off what it is obligated to pay off for depositors in failing institutions.

Now where do you get the money? Well, you can raise a tax or you can do it by a bond issue. So it is additional bonding but it is the way in which the already-existing outstanding Federal guarantee can be satisfied——

Mr. JACOBS. I have got you. We are going through the intersection with a yellow light. Let me just do one more here.

Are you both aware of the fact that in 1984 taxation was repealed on foreign nationals who have portfolio investments in the United States? Foreign nationals who theretofore were taxed for the income, and, consequently, in effect, the U.S. Government is paying an effectively higher interest rate to Japanese businessmen than to its own citizens for those bonds?

Mr. EIZENSTAT. Yes.

Mr. JACOBS. And that adds to the deficit, and that also allowed interest rates to fall in this country because the pressure was taken off of money markets in the United States? Does that make sense?

Mr. EIZENSTAT. I am not sure whether that was the consequence but I am aware of that action.

Mr. Jacobs. And that during the 2 years next following the repeal of that, we were transmogrified from the greatest creditor nation on Earth to the greatest debtor on Earth? Do you accept that as a factor in that?

Mr. Eizenstat. Well, I do not think that is the reason we have become the greatest debtor Nation on Earth. I think it is consequence and effect of running large deficits for a long time.

Mr. Jacobs. It is just a coincidence that it happened to happen in those 24 months immediately following that?

Mr. Eizenstat. I think that may have been a factor but it certainly was not the only factor.

Mr. Jacobs. Thank you.

Chairman Rostenkowski. Mr. Pease will inquire.

Mr. Pease. Thank you, Mr. Chairman, and thank you, gentlemen, for your testimony.

I was interested in your testimony that, "we"—presumably your group—"recognized that with rosy enough economic assumptions it was possible to achieve the $100 billion Gramm-Rudman-Hollings target for fiscal year 1990 without tax increases."

President Reagan submitted his last budget to the Congress about a month ago. Would you believe that the economic assumptions contained therein were excessively rosy, and that is what allowed the President to come up with balance the budget by 1993 and to meet the Gramm-Rudman-Hollings targets for 1990 without tax increases?

Mr. Eizenstat. Yes, and in our assumptions, we took the more modest Congressional Budget Office economic assumptions which are for growth in the 2.5 to 3 percent range, rather than the 3.5 percent range.

And if I may, Mr. Pease, and Mr. Chairman, I really think this raises a very fundamental issue which this committee is going to have to face. And that is that under the economic scenario presented by the Reagan budget, and I suspect largely by the forthcoming Bush budget, although they may cut the economic assumptions a little bit—we are looking at about $27 billion in deficit reduction which has to be made.

Now we believe that figure is closer to $40 billion under realistic economic assumptions. The $27 billion is itself almost twice the level of deficit reduction included in the November 1987 summit agreement, which was only the product of a stock market crash.

So that means that even if you take the rosy economic assumptions, you still have to come up with another $10 billion of deficit reduction above what the Congress and the administration were able to under a crisis scenario.

And what we believe is going to happen is that come August 15, when OMB makes its snapshot, and we look at what the economy is really going to look like—not simply what we are forecasting—that Congress is going to find that instead of having to cut $25 billion, it is going to have to cut closer to $40 billion, and that will bring us right back to this tax issue.

Because while again, through very, very optimistic means you can come up with a deficit reduction that does not include taxes, when August 15 comes around and the real economy is out there, and you are looking not at 3.5 percent growth but 2.5 percent growth, then you are going to have to come to grips with these revenues.

Mr. PEASE. Mr. Eizenstat, on August 15, when OMB makes its snapshot, fiscal year 1990 will not have begun yet, and therefore, if OMB uses a rosy economic assumptions in January of 1989, what is to prevent it from using the same rosy econmic assumptions in August of 1989, even though it will be a little more difficult to do that, considering the closeness of the start of the fiscal year?

Mr. EIZENSTAT. Well, there is nothing, legally, to prevent it from doing it, but the history of these snapshots has been that they tend to take a much more realistic look at the economy because it is so close to the beginning of the fiscal year than you get in January.

So it still may be slightly optimistic, but it would be awfully hard, if we have seen quarters of growth in the 2.5 percent range, to then continue with the same excessively rosy assumptions, although not impossible.

Mr. PEASE. Do you happen to know whether there was a significant difference in OMB's economic assumptions of August 1988 by OMB as opposed to January 1988 for the fiscal year 1989 budget?

Mr. EIZENSTAT. That has been the history. They have generally been slightly lower. I do not have the figure off the top of my head, but they have generally been more in line with what the economy has actually done.

Mr. PEASE. When you quote figures of $27 and $40 billion, is that to get the projected deficit down to $100 billion?

Mr. EIZENSTAT. Yes. In other words, under current services, no tax increases, no tax cuts, no program increases, no program changes—it was our belief, and we said so in the report, that using CBO's assumptions, we would have to make somewhere on the order of $35 to $40 billion in deficit reduction, not $27 billion, and it is that assumption that President Ford and President Carter worked under in coming up with their proposal.

Mr. PEASE. You testified that you met with President Bush and made these presentations to him. Yet you also said just a moment ago, that you really expect the Bush revisions throughout this month to contain essentially the same econmic assumptions that were in the Reagan budget. Is that correct?

Mr. EIZENSTAT. I think they will be slightly lower. My guess is they will be closer to 3 percent rather than 3.5 percent.

Mr. PEASE. I see. Thanks very much.

Chairman ROSTENKOWSKI. Mr. Brown will inquire.

Mr. BROWN. Thank you, Mr. Chairman.

I want to commend both of these gentlemen for the hard work they put in on this document, and this presentation. I think it adds a great deal to the debate and discussion.

One of the concerns that I am left with, though, is that our problem is not a shortage of good and reasonable proposals. Our problem is an unwillingness of Congress to live by them.

In the time that I have been in Congress, which has not been all that long, I have not served in a year where we have ever abided by our budget. There has never been a year when we have not waived the requirement to comply with the budget, many times during the year.

I am wondering if you, in addition to your fine suggestions, have any suggestion as to how we can get Congress to abide by a budget. Ultimately, I think, that is the problem.

Mr. CANNON. We do not have a magic answer to that, Mr. Brown, nor is there one. I think that there is no procedural way you can enforce that. I would like to see a balanced budget amendment myself, but I do not think it is likely to happen soon, and I am not sure that it would work precisely, if it did. I worked on the Hill for 8 years as a Senate staffer, and I marvel at the ingenuity of Members who wanted to accomplish something that was slightly around the restrictions.

Mr. BROWN. We are a creative group.

Mr. CANNON. You are indeed. I think, ultimately, it is the will of the members themselves and the leadership, and in my brief comment, this is why I think this committee has such a powerful role, because I do believe this committee exercises a great deal of leadership in the whole process and the ultimate conclusion of whether we match resources to needs, or whether we do not.

Mr. BROWN. Well, let me put it this way. I mean, you have come with a proposal. Since 1980, we have increased revenue by 76.5 percent. We have increased spending by 80.5 percent. You are coming to us with further suggestions of revenue increases with a knowledge that Congress lives by the revenue increases but does not live by the spending restraints.

Maybe I have misstated something there, and you may correct me, but if that is the case, are we not simply headed off a cliff with this?

Mr. EIZENSTAT. I think that there is one weapon which is really a very effective weapon. It is not a congressional weapon per se, but it is a weapon that Congress has given through the amended Gramm-Rudman process to OMB, and that is sequestration.

Now that is not a very good policy way of cutting the budget, but it is in fact a way of ensuring that the Gramm-Rudman targets are met, and that there cannot be overspending.

It would, as you know, be an across-the-board cut on all nonexempt programs, and that is a very effective way of achieving a result if Congress itself cannot do it. It is not a desirable way but it is an effective way.

Mr. BROWN. Mr. Eizenstat, would you favor a balanced budget amendment to the Constitution?

Mr. EIZENSTAT. No.

Mr. BROWN. Why?

Mr. EIZENSTAT. Because I think it puts the economy and the administration and the Congress in too much of a fiscal straitjacket.

For example, there are times when you do not want to have a balanced budget, such as during the time of a recession, during the time of a war or another crisis. You want the stimulus. Indeed, one would say that we would not have gotten out of the 1982 recession without some degree of budget deficit powering the economy.

In addition——

Mr. BROWN. Well, to that point, would you favor a constitutional amendment for a balanced budget, except in times of war or recession?

Mr. EIZENSTAT. Well, I think, in effect, what Gramm-Rudman does is achieve that but it gives you more flexibility.

For example, there is also a question—and this is why I am against amending the Constitution—it is not an economic document, it is a philosophical document. If you have a slow growth economy, for example, you are not formally in recession but you have got a 1 percent growth rate, there is a very real question, in that circumstance, as to whether you want a balanced budget, because you may throw a 1 percent growing economy into recession.

So I think you want to keep enough flexibility. I understand your concern, and it is a legitimate one.

Mr. BROWN. You understand that, to me, it sounds like you are suggesting to the alcoholic that one little drink every day is pretty good for him.

Mr. EIZENSTAT. I guess what I am saying, Mr. Brown, is—and I understand your concern and frustration at not being able to meet these targets—is that you have really given the administration an extremely effective, almost foolproof tool to use to achieve restraint, and that is sequestration.

Mr. CANNON. Mr. Brown, I would favor a balanced budget amendment as I said earlier, and my feeling is the way to enforce it is not with any attempt at defining war, recession, and so on. It is simply to require that the budget be unbalanced only by some sort of a super majority—two-thirds, three-quarters, or whatever. It is my experience that that would work because I think you can always find a majority, a simple majority to spend a little more, but it is very hard to find a super majority to spend a lot more.

Mr. BROWN. That is an excellent suggestion. Thank you. I yield back, Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. Andrews will inquire.

Mr. ANDREWS. Thank you, Mr. Chairman. I appreciate very much your contribution today. I think this is very useful.

Regrettably, we find ourselves in a straitjacket with these budget deficits, and one of the disappointing things the budget deficit debate has done is push other issues to the sidelines.

I think observers will probably look back on the decade of the 1980's and critique our inability to prepare ourselves to compete in an international marketplace. R&D tax credits, for instance, I think is a prime example, because the first question asked by members of this committee is not necessarily whether or not it is good for our ability to compete but how much will it cost, and can we really afford to do that.

I think the R&D tax credit is one of many things we should be doing to accelerate our corporate ability to deal with especially the companies along the Pacific Rim.

In the last part of your statement you talk about R&D tax credits and give some very positive suggestions of what we need to do.

I wonder if you would elaborate on that part of your statement, both of you, and give us some guidance here. Make some policy of what you think we need to be doing to prepare ourselves for the next decade.

Mr. EIZENSTAT. Well, I think your point is very well-taken, and it really underscores the basic reason why the two Presidents came up with the budget option they did.

It is, again, theoretically possible, with the right economic assumptions to get to a deficit-reduction target, Mr. Andrews, without tax increases. But if you believe, as the two Presidents did, and as our executive committee did, that there are other things to be done in this country besides getting to a $100 billion deficit there are poor children to be taken care of and trained. There is a productivity problem in this country that needs incentives for research and development, as you have mentioned.

We suggested job-training packages. We suggested additional education investments. These will pay for themselves many times over in terms of increased productivity and increased standard of living.

But if we are totally driven by budget concerns, and by not having any revenues, as part of that, then it is impossible, let alone to achieve the deficit reduction targets, to get a kind of productivity package.

And in our summary of our testimony, you do not get a full flavor of the productivity package that the two Presidents proposed, and that our domestic and economic panels proposed in our full report.

It is a full-blown productivity package which includes job-training suggestions, suggestions on education, suggestions for a permanent expansion of the R&D and university basic research credits, and the like.

None of those is really achievable unless we, in addition to spending cuts, come up with enough revenues to pay for them and to reduce the deficit at the same time.

Mr. CANNON. It is true, Mr. Andrews—and both former Presidents recognize this—that the overarching problem is that the budget deficit drives all other decisions by the Executive and by the Congress.

You cannot decide national defense without thinking first about just that point—what will it cost? You cannot think about meeting the social needs, which Mr Eizenstat has just described, whether it is education, housing, the poor, extraordinary needs that should be met in this country, but we cannot do them because we do not even have enough money for what we are doing now.

So what this does, it seems to me, is rob the Congress and rob the Executive of the possibility of setting priorities because priorities are set by the first question, what will it cost?

Mr. ANDREWS. Well, for instance, I would be curious if we could get some revenue estimates on the items that you have described in your statement.

I suspect that we would not just have to have a tax bill. We would have to have a major revenue bill to be able to pay for these proposals, and Stu, I surely agree with you.

I think in the long-run, these kinds of proposals, especially R&D tax credits, are going to pay themselves back, but I do not know how, in this Congress, we can afford all these things and deal with the budget deficits, and try to do it without additional revenues.

Mr. EIZENSTAT. Well, that is precisely why the two Presidents came up with the budget option they did, which had $13 billion in new taxes included.

Mr. CANNON. And some very serious cuts.

Chairman ROSTENKOWSKI. Mr. Pickle will inquire.

Mr. PICKLE. Thank you, gentlemen, for your testimony.

I think your committee, working with the two Presidents, has given us some excellent options, and we should perceive them in a positive manner.

I have a couple of questions I want to ask primarily in the S&L category.

Mr. Eizenstat said in his statement that the committee might consider providing tax incentives to make the acquisition of a portfolio of bad real estate loans an attractive investment.

What do you mean by that? In what way? Are you saying that if you put together a package we might allow investors to write off some losses now curbed by the passive loss rules? What do you mean?

Mr. EIZENSTAT. In our appendix to our report, Chairman Pickle, we have a paper by Peter Wallison and John Petty which goes into this in further detail, but we are essentially talking about some new tax incentives and making it easier for bank holding companies to take over failing savings and loans, and in addition—we did not have a fully fleshed-out option—looking to see if there are not some ways in which these bad real estate loans cannot be picked up by others on the outside.

We felt that the committee ought to take a very thorough look to see if there are not ways in which, with a modest additional credit, we cannot pick some of these bad loans up and save some of the institutions which would otherwise fail.

Mr. PICKLE. Mr. Eizenstat, you are not helping me a bit. What I am trying to say, though, is if you are going to give some credit for bad loans, are you saying in effect that the bad loans that are in an S&L, if they are put together, could be given certain considerations? That is, investors could write off some losses?

Mr. EIZENSTAT. Yes, sir.

Mr. PICKLE. So you are in effect saying that is one option?

Mr. EIZENSTAT. Yes, sir.

Mr. PICKLE. And both Presidents have recommended that along with your committee?

Mr. EIZENSTAT. They recommended that you take a look at it. Yes, sir.

Mr. PICKLE. And I am sure both the S&L's, and the banks, the FDIC, would be for that also. Have you got any response from the administration on that approach?

Mr. EIZENSTAT. We did not on that particular item. Again, as I mentioned, on most of the other suggestions, we find them virtually duplicated in the report. I have not seen the fine print of the Bush proposal, but I did not see that suggestion.

Mr. PICKLE. Well, I know that is a possibility, it has been advanced by some quarters, and there is an appeal to it, to say, if you have got these bad loans backed by real estate in a portfolio, let's give an incentive to move them forward. And that is good in itself, except you have to ask yourself at the same time, what is going to be the reaction to a property owner, who does not have incentives available for his property?

His value will go down. You give extra help to the S&L held property but not to him, and that is another problem we have to resolve.

Mr. **Eizenstat**. It is a problem.

Mr. **Pickle**. But at least you are saying that we ought to look into it and consider that?

Mr. **Eizenstat**. Yes, sir.

Mr. **Pickle**. All right.

Mr. **Eizenstat**. And the reason we do, again, is because you have got a number of institutions which are teetering on the brink.

Mr. **Pickle**. That is right.

Mr. **Eizenstat**. The more that go over the brink, the higher the overall cost of this bailout is going to be anyway.

Mr. **Pickle**. All right. Now what is going to happen in the world of reality when we consider, or if we put into effect—as President Bush has recommended—increasing the premiums for S&L insurance? We have got to get money from some source.

They are paying, right now, to the point where they just almost strangled to death. Many of the institutions in my part of the country, particularly the smaller ones, say they just cannot keep it up; the premiums are killing them. Now you are going to up that another 5, 10, 20 percent.

How can they pay that, because they are just barely making it now, and about the only way they can pay it is pass it on to the consumer?

Now we are going to hear, won't we, or isn't it inevitable that we will be hearing from the S&L's, and both the banks, that they cannot just pay more premiums, that they are about to go under as it is, and now you are going to put another big tax on them?

Mr. **Eizenstat**. Yes, sir. In our recommendation, in the two Presidents' recommendation, they suggests that the interest on these bonds not be paid by an additional fee by the industry because we felt that an additional fee might cause these weak institutions to go over the brink but be put right on the budget and just be a taxpayers' cost.

And yes, you are definitely going to hear, and it is a legitimate concern.

Mr. **Pickle**. Yes. We may have to do both. I make this further observation. I do not know if the best answer is, with respect to the FDIC and the FSLIC, to put them both under Treasury, and have both of them administratively handled by Treasury. They are both independent now. I do not know if that is going to make them any better.

I do not know that we can say that the fault, or the difficulty we have experienced now is because the S&L's have not managed their properties well, or that the banks have not either.

I do not know that the banks are much better off than the S&L's, really, and if you put them under Treasury, you might have some better administration.

The real problem, Mr. Eizenstat, and Mr. Cannon, is that we deregulated. The S&L's wanted deregulation, and asked for it, stood in line for it. The banks, at the same time, agreed when we passed deregulation. They wanted it.

We gave it to both. Now we are paying for it. But to say you are just going to administratively put them under one, I do not know that that cures it unless you go back to the deregulation question and that is something that we are going to be faced with later.

Mr. EIZENSTAT. Well, we did indicate that deregulation was a factor. It was only one factor. Had deregulation been joined with the kind of adequate oversight that the Home Loan Bank Board should have done, then we think that the drastic nature of the problem could still have been avoided.

We also felt that the FDIC was very well run, and that the FDIC was in shape, under Mr. Seidman, to be able to administer the oversight of both of these funds.

Mr. CANNON. As I understand it, Mr. Pickle, part of the plan by the merging is to bring the savings and loans under a form of oversight, greater oversight, which is close to re-regulation.

Mr. PICKLE. Well, who knows where the fault was. You said FDIC was well-regulated and well-run, and the FSLIC was not regulated and well-run. I notice that the former head of that FSLIC said that Congress is at fault because we did not listen to them, and my own observation is that if we ever had a bull in the china closet, it was the fellow that was the chairman of that FSLIC at that time.

It does not do us any good to try to hurl these accusations back and forth. We have got a problem ahead of us.

Chairman ROSTENKOWSKI. Mrs. Johnson will inquire.

Mrs. JOHNSON. Thank you, Mr. Chairman. I consider this to have been a very realistic and thoughtful presentation, and I strongly agree that if we do not spend in some areas where we are not spending now in the coming years, that we will not protect the interests of the Nation in the long-run.

However, I do not think full funding of the programs you mentioned, and expansion of the earned income tax credit—as important as those two initiatives are—are enough.

I think there is a real housing crisis for working families, at least in New England, where rents are simply unaffordable for low-income families, and costs of homes are astronomical now.

There is a significant health-care problem, and teen pregnancy, in my estimation, has to be addressed as a separate, and severe, and critical issue.

So while I see the need for new spending there, competitiveness, and the environment, as you mentioned, I am concerned about your recommendations, particularly in two areas.

Your recommendations in the area of trade strike me as weak. I do not think any package of competitive initiatives can succeed if we do not do a better job. While you recognize the need to enforce the new trade law that we passed, I do not get the sense that you recognize either the urgency or the seriousness of the threat that we face in the international arena from unfair trading practices.

You say that we should enforce the trade policy by using the threat of retaliation. We have used that threat of retaliation sort of ad infinitum with the Japanese. We do not have a coordinated trade policy, and the changes that need to take place in that arena, for us to be able to effectively implement the policy behind the trade bill are enormous, and I just do not get any sense of that urgency.

Was there more breadth to your discussion than these recommendations imply?

Mr. EIZENSTAT. Yes. You know, this is of course a brief summary of a very thick volume. We spent an enormous amount of time on trade with three really excellent people heading our trade study.

Mike Blumenthal who was Deputy STR, Secretary of the Treasury, and is now the chairman of Unisys. Jim Robinson, who was an expert on Third World debt and the CEO of American Express. And Bob Hormatz, who has been a senior official in the last four or five administrations in trade.

And frankly, if we did not do a good enough job of portraying the urgency in our very brief summary, it will come through in the report. We talk, chapter and verse, about how industry after industry has lost market share, how the percentage of our trade vis-a-vis the world GNP continues to precipitously decline.

We urge very strong action in the Uruguay round. We talk about not just the threat of retaliation but using the new trade tools in a few early cases to show that the 1988 act is going to be in fact employed.

We talk about very strong action with respect to the EC, to make sure that the EC 1992 does not become a vehicle to, in effect, put a protectionist penumbra around an internally free market.

There is a real urgency to this, and Jim, you might want to add to that.

Mr. CANNON. Mrs. Johnson, it is true that there are many restrictions against U.S products. I do not have the figures in front of me, but my recollection is that the two biggest reasons we have a trade deficit by far, is that we import too much foreign oil and too many foreign cars.

Restrictions against U.S products are important, and something needs to be done about them, but at the same time, American businessmen need to become more competitive. Many are, but many are not.

Mrs. JOHNSON. Just two quick comments. First of all, the other red flag, to me, was your comment that we need clear rules for U.S. foreign investment abroad. We also need to look at what is happening with foreign investment in America.

Is that investment in America going to bring with it the kind of supplier structure that has kept America's suppliers out of the Japanese markets? Will they keep American suppliers out of the American market?

I see that my time has expired. I do just want to say that the other area where I find your report inadequate is in the area where you talk about reduction of costs. What do we need to do to cut spending? And when I look at what American industry has done to compete, they have cut management costs and improved management. And, somehow, we have to get to that issue rather than just simply looking at the traditional sources of senior citizens and agriculture.

Thank you.

Mr. EIZENSTAT. Well, may I just say on foreign investment that our committee took a positive view on foreign investment. We think that it is a plus, not a minus.

Second, with respect to additional cuts, we developed a whole range of additional cuts and tax increases, from cargo preference on down, that are not just limited to the ones that we mention.

Chairman ROSTENKOWSKI. Mr. Moody will inquire.

Mr. MOODY. Thank you, Mr. Chairman.

Thank you both, gentlemen. I think you have made an excellent presentation, and I think the body of work that you are presenting today really is a tremendous contribution to the debate.

Your statement says that you think we could reach the Gramm-Rudman targets in 1990 without taxes, if and only if the rosy scenario proves true; correct?

Mr. EIZENSTAT. Yes, sir.

Mr. MOODY. In other words, you accept the administration's package if you accept the assumptions. I wonder if that is really true. They get down to $92 billion of which, what, $4 or $5 billion is asset sales, which do not count for Gramm-Rudman, which puts them almost up at the edge with no room for wiggle at all. And if anyone in this room thinks that you can achieve a 3.2 percent growth rate—the blue chip is 1.9 for 1990; these are not small but enormous differences. I doubt if you can achieve a 3.2 percent growth rate, which the administration forecasts, and at the same time see interest rates plummet while we are heating up the economy. The administration believes that interest rates would drop to 5.5 percent on 30-day T bills as opposed to 8 percent plus now. I do not think there is a person in this room or in this town who thinks that is actually possible.

Mr. EIZENSTAT. Mr. Moody and Mr. Chairman, it seems to me that when you look at the budget that is coming out, you should not focus only on the growth assumptions; that perhaps the most sensitive assumption in terms of the budget is the interest rate assumption. The interest rate assumption is for an interest rate through 1989 that is almost 2 full percentage points below the current interest rate, at a time when interest rates are edging higher rather than lower. You change those interest rate assumptions by 1 percentage point, and you are looking at billions of additional dollars of deficit reduction that have to be made.

That is why I say that the rubber is going to hit the road when that August snapshot comes, and we look at what interest rates actually are and what growth actually is. The growth assumptions, frankly, have a smaller impact on the deficit than those interest rate assumptions.

Mr. MOODY. Right. I think that is so. The "if and only if" caveat is probably not going to be borne out, because I do not think many of us believe interest rates will be at 5½ percent as we move into fiscal year 1990.

Mr. CANNON. The interest rate assumption, also, Mr. Moody, has a profound effect on the savings and loans, and particularly those that are fragile. Almost by definition, if interest rates go up more, savings and loans are imperiled immediately.

Mr. MOODY. Right. That is true.

The report suggests consumption taxes. I certainly agree with you on the fuel tax—in fact, I have authored legislation to raise the fuel tax for three sessions in a row now; I am with you on that one. But why do you lump beer and so forth in there? We have some very important policy reasons to promote consumption of fuel: for energy independence reasons and environmental reasons and I can think of others. But why is beer put on the same footing? I mean, what is so bad about beer?

Mr. CANNON. There is nothing wrong with beer and nothing wrong with wine, but our recommendation basically says it should be taxed according to alcoholic content as liquor is now taxed.

Mr. EIZENSTAT. Also, I would say, Jim, that we suggest raising the cigarette tax to 32 cents from 16 cents, which is an additional proposal. Basically, the cigarette tax and the beer and wine taxes have not been increased for a number of years, and just keeping up with inflation alone, it does not seem to us too onerous to have a modest increase.

Mr. MOODY. The regressivity argument did not weigh heavily in your calculation.

Mr. EIZENSTAT. It is regressive. Any consumption tax is, by definition, regressive for sure. But it seemed to us better than no revenues at all or going back and reopening the whole 1986 Tax Reform Act with the can of worms that would occur if we tried to raise income tax rates.

Mr. MOODY. Let me finally compliment the group on having the courage to consider the Social Security question on taxation. All of us agree that Social Security probably could not and probably should not be made a means-tested program on the benefit side. But I fail to see why truly comfortable and wealthy senior citizens should not be treated tax-wise more or less the way other retirement programs are treated. And I could not disagree more with one of my colleagues' comments earlier in this panel that this will make people stop saving. If anything, knowing that you are going to be taxed on your savings might increase your desire to save because you want a target savings nest egg.

It is not clear which way the incentives would go in terms of current workers planning for their retirement if they knew they would be paying some tax. That is an open-ended empirical question. It is not at all clear that it would not have the opposite effect and, in fact, stimulate savings knowing that you would want a greater amount set aside so that your after-tax income nest egg would be roughly in the target that you want.

Any comments?

Mr. EIZENSTAT. Well, we agree.

Mr. CANNON. The number we reached—that is, that you might tax 85 percent of Social Security income for those who are in a middle or high tax bracket—was reached because this is the number the economists we worked with suggested is approximately the amount that the Federal Government contributes to your Social Security, my Social Security; that it is not my contribution. And you pay taxes on your pension for that part that you did not contribute. This, it seems to me, is a simple question of fairness and equity that you pay taxes in the same way on your Social Security pension as you do on your corporate pension.

Mr. MOODY. I commend you and thank you very much.

Mr. EIZENSTAT. I just would say also that, remember, we were working not from an assumption of having to cut $27 billion in taxes, but something on the order of $35 billion in terms of the deficit reduction, because we did not make the rosy economic assumptions that are contained in the outgoing President's budget.

Mr. MOODY. Thanks again.

Chairman ROSTENKOWSKI. Mr. Rangel will inquire.

Mr. RANGEL. Thank you.

Let me congratulate both of you for an outstanding job. Many times during your testimony, you indicated the jurisdiction of this committee. Am I to assume that you gave us a selected part of your report? And is that report available to us now, the full report?

Mr. CANNON. Yes, sir, it is available. In fact, it was sent to your office, to each member of the House and Senate, about 2 days after we delivered it to President-elect Bush.

Mr. EIZENSTAT. We will be sure to get you another copy.

Mr. RANGEL. I would appreciate that.

Mr. CANNON. Before we make a promise here, we are technically out of copies right now. We are having some more printed, but we had a sell-out. When more are printed, we can get you copies.

Mr. RANGEL. Well, I am glad to see that you indicated drugs as one of those problems that we have to deal with in the long run. But it just seemed to me that while you were sharing with us the cost of doing nothing, as it relates to dropouts and foregone productivity in taxes and the annual cost of imprisonment, that drugs would have fit right into that area since there is a such a direct relationship between drugs, poverty, dropouts, the cost of jails and recidivism.

Did you do an in-depth report on that type of thing?

Mr. EIZENSTAT. Yes, we did.

Mr. CANNON. Very much so. We had this as a very high priority throughout the course of our studies, Mr. Rangel. Then, fortunately—and I congratulate the Congress on this—a good bill was passed in the last session of Congress. So we applaud that act that you passed, and, put as a first priority fully fund that legislation that the Congress passed in its last session.

Mr. EIZENSTAT. The drug bill. Let me say that we did try to quantify these costs. We estimated that each year's high school dropout class costs this country $340 billion——

Mr. RANGEL. No, no. Let me interrupt, please, because I am congratulating you on those costs that you have there. They are good figures. I have been using guesstimates myself; now, I can blame you two and say that is where I got my information because I make it up as I go along. But there is no question that when we start talking about the role that drug addiction plays into this and the cost of rehabilitation, the cost of drug addicts to our health and hospital system, that you would have equally dramatic numbers. And if we are talking about budget deficits, I was hoping that in the drug part you did the same thing.

You talk about a good bill that we passed, and I tell you that any bill that is drawn up and drafted on the floor of the House of Representatives in 6 weeks cannot be all that good. It is better than nothing. And I do not know what you did with President Ford or

President Carter. But the truth is that no President has presented to the Congress some strategy to deal with this problem that the Nation is facing.

True, the Congress tried with money to fill the gap, the void, the lack of leadership. But I was hoping—and I suspect it may be in your report—that after talking with past Presidents, that you would recognize that they gave nothing to the Congress in 1986 or in 1988. We just patched and put together something to get us by an election. Now that we are locked into the money, it seems to me that I would like to go some place to find out now what is the strategy.

Can we refine our system of fighting a war against drugs, the same way we locked in billions of dollars for the defense system? And because of the deficit, we now can look at and refine the weaponry system.

Mr. EIZENSTAT. Well, in the drug area—as you will remember, Jim and I came to see you when we first started this enterprise—we had a full-day session with drug experts. We involved both President Carter's and President Ford's drug advisers, their chief drugs advisers. We have proposed two essential things, and it is in great detail in here.

One is full funding of the bill that was passed. But, second, in terms of the philosophy of the direction in which we were going, it is that it has to be more on the demand side through education, through treatment. We suggested, for example, that all people who are referred to the criminal justice system be eligible for treatment, and that that be our goal. Just like we wanted a goal for children to be fully eligible under these children's programs, we recommended that we have a goal of all eligible people referred, or who voluntarily refer themselves for drug treatment, be eligible and that we have funding for that.

Mr. RANGEL. What I was hoping, and I guess we would have to do a lot of work on it, is that once we all agree that you need the money, did anyone tell you how we were going to educate our children? Were any plans there specifically that we can expect the President to bring to the Congress?

Once you say that we should provide treatment—and everyone says, of course, you have got to treat the addict—did anyone come up with any program, anywhere in the United States, where treating the addict was successful? Once you talk about more prisons—and I know you have to since the murders are being committed every day in every city—did anyone talk about the prison system and what we are bringing into the system and what we are turning out of the system?

What I am saying to you is that, yes, the Congress now is willing to respond with dollars, but I have not seen from any President some strategy on specifically how you deal with the problem.

Mr. EIZENSTAT. Well, I am not sure, of course, what Mr. Bush will do, but we do have in our drug paper some specifics.

Mr. RANGEL. Let me really congratulate you. My staff probably was so excited about your work that they denied me the opportunity to share my support with you.

Thank you.

Chairman ROSTENKOWSKI. Mr. Sundquist will inquire.

Mr. SUNDQUIST. Thank you, Mr. Chairman.

I would like to express my appreciation to both you gentlemen for being here. Jim Cannon, an old friend, it is good to see you.

Mr. CANNON. Thank you.

Mr. SUNDQUIST. It seems to me that in the taxing proposal that you have made—some that were accepted by Presidents Carter and Ford, some that were not accepted but needed more study—it is heavily weighted to consumption and heavily weighted toward lower-income people. How can you justify that?

Mr. EIZENSTAT. Well, it is a good question; it is a tough question. All things being equal, some of us might have preferred to have looked at an additional higher rate or the like. But I think that, in essence, it was felt by our two chairmen of the economic panel, Alice Rivlin and Paul O'Neill, and ultimately by the two Presidents, that frankly, if we are going to have a tax, to tax consumption; that that will encourage savings. We need less tax on savings, less tax on income; and if we are going to have to have a tax, to put it on consumption.

Now, you are correct that these particular consumption taxes do have a regressive impact. But we believed, in terms of the overall economic thrust, that it would be far worse to have taxed savings and to tax income too heavily, and that what we do need is to move away from consumption and toward greater savings. We have got a 3 percent, 3½ percent savings rate. It is a third of what it was 10 years ago. It is perhaps the lowest savings rate of the industrialized countries. And by taxing consumption, we might encourage savings.

Mr. CANNON. We were reluctant at this point, Mr. Sundquist, the Congress having just gone through a series of years of tax increases, we were reluctant and the Presidents, I should say, were both reluctant to propose changing the income tax rates at this time.

Mr. SUNDQUIST. Thank you, Mr. Cannon.

When you talk about consumption discouragement, are you referring to gasoline, not cigarettes and alcohol, Mr. Eizenstat? You said "discouraging consumption." You were referring only to gasoline?

Mr. EIZENSTAT. No, absolutely not. Discouraging consumption of cigarettes and alcohol, we thought—again, if one has to have a tax—that is something one could well discourage.

Mr. SUNDQUIST. How can you justify inflicting your morals on the country by a tax system?

Mr. EIZENSTAT. Well, every tax makes some moral judgment, and if you are going to tax consumptions, the question is: What are you going to tax? You can tax luxury items. We certainly could have come up with a luxury tax. But if I had to choose between these three, I would tax motor fuel—and I am speaking for myself now, but I suspect the two Presidents would have agreed. I do not think it is a moral judgment. I think it is a damned hard-headed economic judgment to tax fuel because, as Jim said, we are increasingly dependent on foreign oil. It is the biggest single item in our trade deficit.

Mr. SUNDQUIST. I understand that.

Mr. **Eizenstat**. And I do not think that is a moral judgment at all. I think it is an economic judgment.

Mr. **Sundquist**. That is why I asked about the other so-called "sin taxes" that you said. I understand there is no moral judgment in gasoline.

Mr. **Eizenstat**. Well, if I had to choose between the three, I would rather triple the fuel tax than I would go to the others. But that is a personal choice.

Mr. **Sundquist**. Did you all consider, Mr. Eizenstat, the economy of savings in the Federal Government by shifting some programs back to States?

Mr. **Eizenstat**. Yes. We have a discussion of federalism and the need to devolve some social service and infrastructure programs back to the States.

Mr. **Sundquist**. I have not read the entire testimony. I was a few minutes late getting here. Is that in there, the shifting?

Mr. **Eizenstat**. It is not in the testimony, but there is a discussion in the report on the last panel on decisionmaking, and there is a brief section about that.

I have done some personal articles about it, suggesting ways in which some programs can be devolved to the States.

Mr. **Sundquist**. Mr. Cannon, as one who worked on the revenue-sharing very early, I consider it to be a strong proposal, a very worthwhile proposal that was working, that shifted programs back to the States and ultimately shifted some taxing opportunities back to the States. What would your reaction be to a proposal that we would take many of these alphabetical agencies that exist in the Federal Government, and just reassign the money—EDA, UDAG, Appalachian Regional Commission, TVA and on and on and on with one-third of that money reducing the deficit, and the other two-thirds going back to States. The revenue-sharing concept would exist at less than one-fourth of 1 percent, and we could help the infrastructure, where the locals could administer the programs more sensibly? The Federal Government saves a third of what we spend; the cities and counties would get money to assist in this for capitalized programs and infrastructure.

What is your reaction to that?

Mr. **Cannon**. I would commend that enthusiastically, Mr. Sundquist. I think that the principle that you have articulated there is the most sound one. I think that the program, the revenue-sharing program that we did have for, I guess, 12 years, was one of the most efficient we have ever had. I think it still holds the record for having the lowest Federal overhead of any program. My recollection is that the cost of administration was less than one percent, or something like that. And it strengthened the local community. It strengthened the States. It gave the local community the right to make a choice about what it felt were its most urgent local needs. And I know in the State with which I am most familiar, New York State, it was by far the best Federal program, the most effective Federal program.

Mr. **Sundquist**. Thank you very much.

Mr. **Eizenstat**. I would just say I would want to look at that on a case-by-case basis rather than just lop off a third of every program and devolve it.

Mr. PICKLE [presiding]. Mrs. Kennelly is recognized.

Mrs. KENNELLY. Thank you, Mr. Chairman.

Gentlemen, think about the savings and loan situation and the boomlet that the people would directly pay the tax to bailout the savings and loans, and then, of course, the back-off of that idea on the one hand, and on the other you say on page 10, "We recognize that with rosy enough economic assumptions, it was possible to achieve the $100 billion Gramm-Rudman-Hollings target of 1990."

As two very astute advisers of Presidents, can you tell me, hearing what we are hearing day after day about no new taxes, no new taxes, if you think we are going to be able to do anything this year? Or will we have to wait until the following year to go to the traditional taxes, such as the sin taxes or drastic ideas like taxing Social Security? Do you really think, knowing the political realities of life as you do, that we as a committee or as an arm of Government can go against this denial of the need for increased taxes?

Mr. EIZENSTAT. Well, we are now, Mrs. Kennelly, in the area of making assumptions and hypotheses. My personal belief is that when the OMB snapshot comes out and we find that we have to cut around $35 to $40 billion, that it is not going to be possible to do it without some revenue increases even in this year.

Mrs. KENNELLY. Even in this year.

Mr. EIZENSTAT. That is my personal belief.

Now, I think the administration is going to do everything humanly possible to avoid that. And, certainly, in their initial budget coming out this week, even though I think their economic assumptions will be not quite as rosy as the ones of the Reagan administration, they will be sufficiently optimistic so that, at least on paper, that can be done.

But I think when we go to that August snapshot and we see that growth is probably not going to be as high as even the Bush numbers, and we look at what we took for our assumptions, that it is going to be very, very difficult to avoid this year. Certainly, it will be impossible to avoid next year, because then you go from 100 billion Gramm-Rudman target to 64——

Mrs. KENNELLY. I am not worried about next year, Mr. Eizenstat. It is this year.

Mr. EIZENSTAT. Yes, my belief, my personal belief, is that it is unavoidable this year unless growth really is 3½ percent.

Mrs. KENNELLY. Well, Mr. Eizenstat, what will be the impetus? Will it be that if we do not raise the taxes ourselves, Gramm-Rudman kicks in?

Mr. EIZENSTAT. Yes. The impetus, Mrs. Kennelly, will be sequestration. And, ultimately, I think the President of the United States is going to have to make a decision. Does he want sequestration to come in? Which means that half of all sequestered funds have to come from defense.

Let us just make a working assumption that we have to cut $35 billion from the budget, and half of that has to come from defense. That is, say, $17 billion from defense. To cut outlays in defense by $17 billion is going to be cutting budget authority for defense by $25, $30 billion. It is an astronomically high defense figure.

Now, I think Mr. Bush is going to have to make a judgment at that point. Does he keep his campaign promise, or does he let defense take that enormous whack? If he wants to keep his campaign promise, it is technically possible for him to do it. But it will mean an enormous sacrifice in the defense area.

Mrs. **Kennelly**. So the rationale will be: I wanted to keep my campaign promise, but Gramm-Rudman keeps me from keeping it?

Mr. **Eizenstat**. Keeps me from doing it because it would weaken our defenses. And he would then go through the whole year arguing for not having them, and then reluctantly have to pull back.

That is my personal assumption. But, again, if he wants to keep his commitment—and you look at realistic growth assumptions—then he would simply let sequestration go into effect, take the hit on defense, and say, "I kept my promise."

Mrs. **Kennelly**. It is a possibility, though.

Mr. **Eizenstat**. It is a possibility.

Mrs. **Kennelly**. Thank you, Mr. Eizenstat.

Thank you, Mr. Chairman.

Mr. **Cannon**. Mrs. Kennelly, could I say one other thing? The emphasis of this report was not directed to Mr. Bush or to Governor Dukakis. We emphasized in this report that we wanted to look, as best we could, at the facts as they are and then present options for what might be done about them.

Now, Stu has articulated very well. We are going to get to the point somewhere where you have to reduce national security or pay for it. And how we do that, I do not know, but that is the crunch. That is what is going to happen.

Mr. **Eizenstat**. In our defense paper, too, Mrs. Kennelly, Brent Scowcroft, by coincidence, wrote our defense paper. He was on our executive committee; of course, he is now national security adviser to the president. And when you listen to what Brent told us about, quite apart from Gramm-Rudman, the cuts the Pentagon is already making from what they had projected a couple of years ago, they are already cutting $200 and some odd billion out of their projected figures. Then they have to yet take another cut.

You are really getting into the sinew and fiber of defense if you are going to let sequestration go and avoid a tax increase. But that is the ultimate choice I believe the President of the United States is going to have to make.

Mrs. **Kennelly**. Mr. Eizenstat, I am aware of that. And I have, by the way, read your paper and used your paper. It has been incredibly helpful to me when I am making my remarks because it is so well ordered. But I read the paper and I listened to Mr. Cannon's remarks when I came in today, and I just think what has to be in the equation—even though the paper was not directed at Mr. Dukakis or President Bush—is the fact that this promise is still being kept more seriously by the President, highlighted by the S&L situation, than any of us thought earlier on in the year.

So I think the possibility that we are getting down to is what you are saying, Mr. Eizenstat: Keep the promise, and then you have to decide between the promise or Gramm-Rudman. I think that scenario is playing out. And, Mr. Cannon, you said as a committee we are tough; we make the tough decisions. I have a feeling we are not even going to be asked to make them until the following year.

Mr. **Eizenstat**. I believe you will.

Mr. **Cannon**. I do, too.

Mrs. KENNELLY. OK. We will see.

Mr. PICKLE. The Chair recognizes Mr. Donnelly.

Mr. DONNELLY. Thank you, Mr. Chairman.

Gentlemen, welcome, and thank you for your excellent presentation. I just have one specific question.

On page 10 of your presentation, you made a recommendation to cap physician fees under Medicare. Exactly how would the cap work, Stu?

Mr. EIZENSTAT. We did not go into detail on this. We basically took this from some suggestions that have been made by CBO. We estimated $10 billion, and the way we did it is that there is increasing talk about having the kind of DRG-type of concept for doctors that hospitals now have; that is, a sort of valuation of particular services. You simply set a Medicare-cap on what is paid on a service-by-service basis for physicians. So it really is carrying over the DRG concept that is now applied by the Congress to hospitals to physician reimbursements under Medicare.

Mr. DONNELLY. What about the issue of balance billing? Is this included?

Mr. EIZENSTAT. Yes, this is a possibility.

Mr. DONNELLY. So you are recommending a prohibition on balance billing or so-called mandatory assignment?

Mr. EIZENSTAT. Yes, that is an option.

Mr. DONNELLY. Any recommendation on hospital cost?

Mr. EIZENSTAT. Not beyond what is done. We think we are making some progress on the hospital side. We continue to need to crunch down on the DRG's, but we did not have any specific recommendations beyond that.

Mr. DONNELLY. Just one additional followup question on Mrs. Kennelly's line of questioning, and that is the whole issue of the pledge no new taxes. And I think that probably is the fundamental reason why George Bush beat Michael Dukakis was because he made that pledge.

We are in the position on this committee of having the responsibility over revenues. You have an individual that is elected President of the United States on the pledge there will be no new taxes. How do you break that pledge to the American people without increasing cynicism amongst the electorate?

You know, we are now, at least from my side of the aisle, starting to receive postcards drummed up by the Republican National Committee saying, you know, George Bush made the pledge and we hope that you will work with him to keep the pledge. When we know the realities of Gramm-Rudman, we know the realities of the so-called flexible freeze, how can we be responsible when the other side was not and is not? It makes it very difficult.

I applaud you people for being bipartisan and trying to come up with a package, but the reality is today there does not seem to be any movement from 1600 Pennsylvania Avenue to deal with reality, other than stay in the political arena?

Mr. EIZENSTAT. If I may respond to that, and Mrs. Kennelly mentioned this earlier, that there was a greater assertion of this campaign promise.

I, for one—and I think Jim has gone through campaigns also—believe that campaign promises do mean something; and if they are lightly abandoned, it does increase, as you indicate, cynicism. And I think that is the very fact that Mr. Bush is facing now. He does not want to be in a scenario where 30 days after he has been inaugurated, he suddenly submits a budget which contradicts what he said.

There are two points, however, on that. Point No. 1 is the reality of the OMB snapshot in August, and then facing the dilemmas: do you want to take that huge cut on defense or keep your commitment. I cannot get into his head. I do not know what he is going to do on that, but I think it is a very, very tough—maybe the most important—choice he will make as President.

The second point, and one that is emphasized at great length in our report, is that if there is not an early bipartisan agreement on the budget, you are really rolling the dice in terms of what the foreign markets are going to do. The administration, if they come up with a budget that is not accepted as fully credible, is really betting on the fact that the foreign markets are going to sit back, wait until the August snapshot, wait until everybody has to really make those tough decisions in August and September, and will have a benign attitude toward the dollar in the meantime.

That is a great risk. There is an equal risk that seeing this continued impasse between Congress and the administration, which was broken in November of 1987, that foreign markets will conclude that we are not going to deal with this situation. The dollar will plummet; interest rates will have to go up. We will be in a recession. That is an equally plausible scenario.

You know, we felt with a great sense of urgency, which I hope comes through in this report, that we cannot take that risk, we cannot roll those dice for 9 months and hope that the——

Mr. **Donnelly**. The problem with the bipartisan agreement process is that the administration would like to make an agreement between three of their leaders and three of our leaders and come to agreement and bring the rest of us along to sort of rubberstamp that agreement. And we did that before. But, institutionally, there is a lot of concern about the role that we have as individuals in a coequal branch. Very frankly, amongst at least the Democratic caucus, there is going to be very much opposition to our leadership agreeing to that type of process which basically takes us out of the process.

Mr. **Cannon**. On this question, I have heard Candidate Bush and now President Bush say no new taxes. I have heard those words repeatedly. I do not know what he is actually going to do, Mr. Donnelly, but I do know this: I know that Presidents do change their minds. They do successfully change their minds, and they are often applauded for it.

I do know that Governors raise taxes, and raise taxes often for specific purposes, and usually they are applauded for that as well.

I think Presidents ultimately demonstrate leadership, and exactly how this is going to go, I do not know yet. But I do believe, as Stu said earlier, when the crunch comes, that the right decision will be made.

Mr. **Donnelly**. From my perspective, I would give him all the time he needs to change his mind. But if he does not change his mind, and the economic scenario that Mr. Eizenstat laid out takes effect, then the pox will be on his house, not on this one.

Mr. PICKLE. Mr. Downey is recognized.

Mr. DOWNEY. Thank you, Mr. Chairman.

Let me just say that I have read a synopsis of your report, and I really think it is first-rate work. It is enormously helpful to me, and I think to the country, to have President Carter and President Ford and what you have done as a backdrop, at least when we discuss what needs to be done in this country in a bipartisan way. And I thank you both very much for it.

I would like you both to address—I came from a press conference, the reason I was late, where Congressman Miller, myself, Congressman Lewis and Senator Gore have introduced a fairly dramatic change, that we would like to think is a dramatic change, in the earned income tax credit. We have expanded it, and we have made it adjustable for family size. We have made refundable the dependent care credit so that the poorest of people who want to go to work, who need to have some benefits, will be able to get them. And we have also expanded title XX of Social Security. It is a $34 billion package over 5 years, and we pay for that by eliminating the bubble in individual tax rates. If you are familiar with that, it is that bend point in the income Tax Code now where people earning by 1990 $208,000 of adjusted gross income go from a 33 back down to 28. They would stay at 33.

Now, admittedly, you have not had a chance to see it, but your report deals so effectively with the working poor. Stu, if you could, talk a minute about this as a concept. I know that you say growing up in poverty—both of you; Mr. Cannon, also—placed the proper emphasis on child poverty. I do not know that we cannot proceed in tandem with these things. The poor are poor because they do not have enough money. They do not have enough in the way of options. And I would like to get your feelings about this idea of expansion of earned income tax credit refundability of the dependent care credit, and how it fixes into the mix of priorities and things that we need to deal with.

Mr. EIZENSTAT. We did not deal with the dependent care credit, but we did deal specifically with the expansion of the earned income tax credit. We did in our domestic panel section suggest expanding it for family size, varying it by family size. And we felt that it was a more targeted, less inflationary way of helping the working poor than raising the minimum wage, if one had to choose between the two.

Mr. DOWNEY. Did you want to add anything?

Mr. EIZENSTAT. I applaud you for taking it on.

Mr. CANNON. I would agree with that.

Mr. DOWNEY. Can we just think together? I only have 4 minutes, probably only 2 minutes now. Demographically and economically, the economy seems to have responded by creating jobs at low wages. Could I read from your report, and would you address it more specifically, that it must be a fundamental responsibility of Government to make sure that people who work full time are not poor? I mean, can we agree with that as a concept?

Mr. CANNON. I would.

Mr. **Eizenstat.** Yes. We estimated that 15 percent of all poor families have a head of household working full time; 47 percent have a head of household working at least part time but 15 percent full time in jobs that simply are earning below the poverty line.

Mr. **Downey.** Is it not also fair to assume that as we internationalize our economy and as manufacturing jobs inevitably go to those places where the labor costs and inputs are less, that we are likely to see more of this not less of this in terms of job creation at lower levels?

Mr. **Eizenstat.** Yes, because unit labor costs in the end are what really matter in terms of competitiveness. Therefore, keeping down the cost of labor is going to be one item.

Now, frankly, the way you avoid having to depress our wage scale, which no one wants to do as a real solution to our productivity problem, is by being more productive overall. If you can have the kind of staggering increases in productivity the Japanese have, you can do a lot.

Mr. Chairman, one of the things that I found fascinating, if you look at wage rates from 1980 to 1988, you will find that the Japanese were paying in 1980 about 60 percent of the wages per hour we were paying. In 1988, the Japanese manufacturing wage per hour is higher, as it is in Germany, than in the United States. That was not true only 8 years ago. Now, how could they afford it? Germany has a 1 percent inflation rate. Because they have got these staggering increases in productivity.

Mr. **Downey.** Aggregate productivity is difficult to measure. I mean, this fellow Dennison has done all of this study. Clearly, it is contributed to by the fact that you have——

Mr. **Eizenstat.** But we used to make the argument that we cannot compete against the Japanese because they are paying dirt cheap wages. The fact is they are now paying higher wages than we are.

Mr. **Downey.** Well, they can afford to because of their productivity increases.

Mr. **Eizenstat.** That is exactly right.

Mr. **Cannon.** And they raised that productivity by education and by research and development, and by good and better manufacturing techniques. We have lagged, to a great extent. We took too many things for granted for too long.

Mr. **Downey.** Yes. Well, again, I thank you for your very fine work. It is much appreciated.

Mr. **Pickle.** The time of the gentleman has expired.

The Chair announces that, unless there are other questions, we will recess until 2 o'clock this afternoon. We thank the committee for appearing with us this morning. Your suggestions have been good. They have been broad, but they have been very positive. The committee appreciates it.

Mr. **Eizenstat.** Thank you, Mr. Chairman.

Mr. **Cannon.** Thank you, Mr. Chairman.

Mr. **Pickle.** We will recess until 2 o'clock this afternoon.

[Whereupon, at 11:58 a.m., the committee recessed, to reconvene at 2 p.m.]

AFTERNOON SESSION

Chairman ROSTENKOWSKI. The committee will resume its sitting. This afternoon we will continue to hear testimony on the budget and state of the Nation's economy.

Our panel of witnesses include James Tobin, a Nobel laureate in economics, Larry Summers, a professor of economics at Harvard, and James Miller, a ~~former~~ Director of OMB.

Welcome, gentlemen. Welcome to the committee. We look forward to discussing the reasons deficit reduction is important and to hearing your recommendations about how to reduce the deficit and continue the economic growth.

I want to suggest that I would like each of you to make a statement, and then engage each other, and members of the committee in a discussion.

I think that writing that record will certainly serve us when we are in the deliberations stage of putting something together.

Dr. Tobin, if you would like to begin.

STATEMENT OF JAMES TOBIN, PH.D., STERLING PROFESSOR OF ECONOMICS-EMERITUS, YALE UNIVERSITY, NEW HAVEN, CONNECTICUT

Mr. TOBIN. Thank you very much, Mr. Chairman.

Thank you especially for going in reverse alphabetical order, which seldom happens.

Well, I think people are getting a little tired of the budget deficit. As a matter for discussion it is tiresome. Almost everything that could be said about it has already been said.

I have organized my statement—I have given you a copy of the written statement—in seven questions, which I am going to ask myself, so to speak.

Is it really important—this is the first one to reduce the Federal deficit, and if so, why?

I do not think you can infer from the fact that we have had a long and good recovery from the recession of 1979 to 1982, that all is well we need not worry about Federal fiscal policy.

I believe we could have had the same recovery, reducing unemployment and containing inflation, without an abnormal and unprecedented deficit-spending policy such as we had in the last 8 years.

It could have been done by having a more normal monetary policy with lower interest rates. This would have brought a recovery with the same mix of fiscal and monetary policy that we had in the whole postwar period prior to the 1980's.

You could say that the recovery was a demand-side triumph, largely for the Federal Reserve. The Fed has been steering the economy along a path of steady growth, and now have gotten us close to or at full employment.

Strangely enough, the recovery has been a supply-side disappointment. The bottom line of supply-side policies would be to raise the rate of growth of productivity. The rate of productivity growth was nearly 3 percent from the end of the Second World War to 1973, and then it went down to around 1 percent and it is still there. 1.4 percent, I believe, is the most recent estimate, for last year.

Real wages usually reflect the growth of productivity. They have not even done as well as that in the recent period. Real wage growth has been about half the rate of growth of productivity. Real wages have been stagnant.

So if the purpose of supply-side policies was to accelerate the growth of the capacity of the American economy to generate ever-increasing wages and living standards, it has failed.

The recovery of the 1980's added a lot of jobs, about a 15 percent increase in employment, but did not produce a lot of output, only 26 percent. The recovery in the 1960's, over about the same length of time produced 33 percent additional output with 13 percent more employment.

I bring this subject up because I think the main reason to worry about budget deficits remains as it always has been, the effect on the long-run growth of productivity in the United States.

Deficits are bad supply-side policies. The reason is that they absorb a lot of national saving, and we need more national saving. We need more national investment to provide tools and technologies that augment the productivity of workers.

Instead, we have been engaging in a consumption binge in the 1980's, a consumption and defense binge, if you like, which our children's children are going to pay for.

They will be able to earn less and consume less than if we had been following a more prudent and less profligate policy.

The rate of national saving in the United States is pitifully and shamefully low. I am going to talk about net saving, that is saving net of allowance for depreciation, and relate it to net national product, leaving capital consumption out of income and output as well as out of saving and investment.

That is the way you would do it, if you were doing the accounts for a household or a business, and that is the way we ought to look at it from the point of view of the Nation.

National saving is the sum of non-Federal saving—the savings of households, businesses, and State and local governments—and Federal saving. Federal saving has been negative, especially in the last decade.

Non-Federal saving has been declining. It is now roughly 6 percent of net national product. Before the 1980's, the norm for national saving was 8 or 9 percent. Now, if you take the non-Federal saving of 6, and subtract the Federal dissaving of 4—or now, getting down to 3, but not there yet—we have an overall national saving rate between 2 and 3 percent.

In the pre-1980 period the Federal Government was not significantly dis-saving on average, and we had 8–9 percent non-Federal saving and investment. Most of that was going into domestic investment. We were running a modest trade surplus, gradually building up our net foreign wealth. Our net domestic investment is down to 6 percent now, and we finance that with the 2 or 3 percent of saving left over from financing the Federal deficit, and from borrowing abroad 3 or 4 percent of net national product. We are incurring a debt which will be a burden on our children, and our children's children to service. We have not done anything productive with the borrowing.

There is nothing wrong with household borrowing from others, or a business borrowing from others, or a country borrowing from others, if they use the borrowed funds to engage in activities that yield a higher return than the interest they have to pay. As a nation, we have done the opposite.

I will not even go into the familiar international comparisons that show our saving rate to be so low relative to those of our allies, other advanced capitalist democracies, and our competitors in international trade.

One figure will make the point. Our Federal deficit takes half to maybe two-thirds of the available non-Federal savings. Japan has a central Government deficit of about the same size as ours relative to national income, but it takes only one-fifth of the saving of the Japanese people.

The second question is: Isn't the deficit overstated? There has been a lot of public discussion of that recently. It depends on how you define national accounting concepts. You could do it differently from the way we have been doing it.

For example, you could try to make a capital budget for the Federal Government and give it credit for investing in durable assets for the Nation, the way we do for businesses and for households. Likewise, you could make corrections for inflation in calculating interest charges on Federal debt.

But the point is that no matter how you do it, the deficit in the 1980's has been much, much bigger than it was in the 1970's, 1960's, or 1950's, in relation to national product.

So you cannot define away the fact that there was a big deterioration in the Federal fiscal position in the 1980's. Conceptual changes alter the numbers back in the old days as well, and it will alter them for other countries, too. The comparisons will still look bad. Measuring deficits and saving differently is mostly irrelevant to the questions of policy that face us—even if one wanted to make the corrections that are sometimes suggested, which are not obviously improvements anyway.

In one important way the Federal deficit is understated today. I am going to come back to that. It has to do with the Social Security surplus.

The third question I want to discuss is: Isn't the Federal debt smaller relative to national product than it was after World War II until 1963? Weren't those years of prosperity and rapid growth? If we could handle a debt of that magnitude then, why can't we handle it now?

Well, there are several big important differences. One is that from 1946 to 1962, deficits were smaller even though the debt was large, and the growth of GNP was greater. So the ratio of debt to GNP was going down all the time, not remaining constant, or threatening to rise. Its rising trend began in the 1980's, not until then.

Second, non-Federal saving was much more plentiful in those days than they are now. There was a lot of room in the economy for investment without resorting to foreign borrowing. Indeed, we had export surpluses. Our overseas wealth was increasing; it is now declining.

Third, interest rates, both nominal and real, were low. Service to the debt was a much smaller burden relative to GNP in the 1940's, 1950's and 1960's than it is now, even though the debt itself was larger. That is because interest rates are so much higher now. And why are they higher?

Well, they have been higher in the 1980's because the Federal Reserve has had to spare the economy the overheating that would otherwise have resulted from the spending of the large tax cuts and from the defense spending buildup.

Right now, when the economy is close to its capacity, it is necessary for the Federal Reserve to keep interest rates high enough to prevent overheating and resumption of inflation.

By the way, the evidence is, most economists agree, that the potential rate of growth of the capacity of the economy to produce these days is around 2.5 percent per year. And if, indeed, we are at about as low an unemployment and excess capacity position as is safe from an inflation point of view, then projections that say the GNP is going to expand at 3.2 percent per year, or more, from now on, and at the same time as interest rates are going to go down, are just not credible. They give an over-optimistic view of what will happen to the budget.

It is also true that high interest rates feed back into higher deficits themselves. That feedback could even turn into a vicious circle, since the higher deficits make it necessary for the Federal Reserve to have higher interest rates, and those, in turn, make for higher deficits.

And if you have interest rates which are higher than the growth rate of the economy, then just for that reason alone, the debt will grow faster than GNP grows. We are close to that situation even right now.

Mr. GIBBONS. Would you repeat that for me. Not that we are closer there but——

Mr. TOBIN. I am sorry. I could not hear you.

Mr. GIBBONS. Would you repeat that statement you made just a second before you said we are closer to that period now.

Mr. TOBIN. I will elaborate the point. If the interest rate that the Government has to pay on its debt, making allowance for the taxes that are paid back to the Government on the interest itself—if that rate is higher than the growth rate of the economy, then even if other outlays of the Government are covered by tax revenues, the debt will grow faster than the economy, and the debt-GNP ratio will rise.

We have been close to that position earlier in this decade, and now that interest rates have been going up again because of the tightness of the economy, we are getting close to it again.

By the same token, if you could cut the deficit by tax increases or expenditure reductions, then that in itself would make it possible to have lower interest rates. The Federal Reserve would not be so scared that the Government was overheating the economy. There would be a bonus, which would make for a still larger eventual reduction in the deficit than the initial cuts or tax increases.

Another question: Would cutting the deficit now cause recession? Well, my answer to that is no, it need not have that effect, because the cut in Government expenditures—or the cut in consumption due to higher taxes—would make room in the economy for additional demand. The Federal Reserve would have reason, then, to lower interest rates to induce additional demand, including possibly an improvement in the trade balance as lower interest rates lower the dollar and stimulate and improve the exports of the American economy relative to imports.

The main hazards to the economy right now, I think, will arise if nothing is done about the deficit. Given the depreciated dollar, there is a possibility that markets will push it still lower, and then the production of exports, and import-competing goods should be improving. Also, given the high prosperity of the economy right now, domestic investment could be strong. But there is no room in the economy for expansion of those desirable claims on national resources.

So, without any change in the deficit position, the Federal Reserve is likely to see inflation as the principal danger. As they raise interest rates, we might—not by intent but by accident—easily slip into recession.

So—here's the bottom-line question—do we need new taxes? My opinion is definitely yes. For two reasons. One is to lower the deficit, and the other is to finance essential and desirable expenditures that are not now in the budget.

It is still unreasonable, I think, to count on growing out of the deficit. It is especially unreasonable in view of the many compelling new claims on budgetary resources that are now being recognized: the rescue of the savings and loan depositors; the modernization of nuclear weapons facilities; the deferred maintenance and expansion of the Nation's infrastructure—transportation, public health; education from infancy to graduate training and basic research; the war on drugs; day care, and child care; something to do about the homeless and the shortage of low-cost housing; welfare reform, and the associated jobs and training; rehabilitation of the pathological urban neighborhoods; international operations; environmental protection, and so on.

I guess the base-line reference budget in the latest CBO report does not even include allowance for the census, the space shuttle, the superconductor supercollider, and other things that are in the cards.

Now it is true, as many people point out, that Federal revenues are the same percentage of GNP as they were 10 years earlier, and outlays are 1.7 points higher.

But the composition of both sides of the budget has changed drastically. Social Security revenues are what has increased on the revenue side by 1.3 points, while regular tax revenues—corporate and individual income taxes—have declined by the same amount, 1.3 points of GNP.

Interest outlays have increased by 1.5 points, defense by 1.3 points, and entitlements by .9. Leaving Social Security aside, in 1979 the excess of regular income-tax revenues over defense and interest outlays was 5 percent of GNP; 5 percent of GNP was available to the Federal Government for civilian discretionary spending without borrowing.

But in 1988 that margin was only 1.1 percent of GNP. Essentially any excess of civilian discretionary spending now, over 1 percent of GNP, has to be met by borrowing, and in fact such spending is down from 5.5 in 1979 to 3.7 in 1988.

Finally, should Social Security surpluses be counted as deficit reduction, I say definitely no. I have already argued that national saving is very low, and even if we did not have a Social Security problem, we should increase our national saving to restore it to where we were before the 1980's.

But we do have a Social Security problem, an additional need for saving. The fact that we are having this big demographic transition in the coming decades, well into the 21st century, means that we need even more of an increase in national saving.

The number of active workers per elderly retiree is going way down. It is in process. A ratio of 5 to 1 active workers to retired in the 1960's is going to go down below two in the middle of the 21st century according to demographic projections. It was for that reason that the Congress, in 1983, in the compromise Social Security legislation, provided for an increase in reserves in the trust fund to handle the Social Security situation in the 21st century.

That is a special problem arising from this demographic transition and requires additional saving. That saving should not be counted as solving our budgetary or saving problem. Congress should look upon off-budget funds as truly off-budget, and should regard its increasing debt to the Social Security trust fund as if it were a debt to the general public, which in effect it is.

It is a debt to future beneficiaries of Social Security, and it would be a shame if we thought that we had solved the deficit problem by the fact that this surplus will build up from $56 billion this year to $117 billion in 1994.

We should change the focus of fiscal policy from the unified or total budget deficit, to the on-budget deficit which does not count what is happening in the trust fund. That means that the budget deficit that we now focus upon needs to be even better than balanced, running a surplus corresponding to the buildup of the Social Security fund.

By the way, the figure that I appended to my written statement was meant to show that interest rates are high when the deficit is high. What it does is plot average real interest rates—correcting for inflation—in seven business cycle recoveries in the United States since the Second World War. And if you have that in front of you, you will see that all the previous recoveries—six of them—in all of those, the budget surplus or deficit was around zero, close to it, on average, over the recovery period. Also, the real rate of interest was close to zero.

The one recovery period that stands out as different from that is the 1983–87 period, where the budget deficit is more than 4 percent on average and the real interest rate is between 4 and 5 percent on average. That is the consequence of the mixture of monetary and fiscal policies that we have gotten ourselves into, and that we should now try to get out of. Thank you.

[The statement of Mr. Tobin follows:]

ON THE FEDERAL BUDGET DEFICIT

James Tobin, Yale University
Statement to the House Ways and Means Committee February 7, 1989

The federal budget deficit is by now an old and tiresome subject, on which virtually nothing new can be said. I have organized my remarks as answers to seven questions which frequently come up in current discussions.

1. Is it really important to reduce the federal deficit? If so, why?

No catastrophe has yet occurred, no day of sudden and final reckoning. Instead we are enjoying a long non-inflationary recovery, which has brought unemployment rates lower than almost all economists thought possible ten years ago. The recovery, it is important to understand, is a demand-side success. It has been skillfully managed, one could say "fine-tuned," by the Federal Reserve. Although the Reagan tax cuts and defense buildup stimulated demand for goods and services and for labor, they were not essential to the recovery. As I shall explain later, the Fed could have managed the same recovery with a more normal fiscal policy implying much lower budget deficits.

The recovery has been a supply-side disappointment. The 15 percent increase in employment since 1982 did not produce a lot of output, only a 26 percent increase in real GNP. (In 1961-67 a 13 percent increase in employment yielded a 33 percent gain in output.) Productivity growth has not revived from its post-1973 slump; from 1948 to 1973 it was 2.8 percent per year, and now it remains at 1 or 1 1/2 percent. Real wages generally advance with productivity, but lately they have not even done that well. Productivity growth is the bottom line of supply-side policies, and so far they have failed this test.

Chronic large budget deficits, run in prosperities as well as in recessions, are bad supply-side policies. They work against the productivity growth this country needs to compete in world markets while yielding the steady gains in real wages and living standards that Americans expect from their economy.

That is why I continue to say that deficit reduction deserves highest priority. I say so not because I expect the growth of federal debt to bring a disastrous financial and economic crash like 1932-33. The consequences are gradual and insidious, an erosion of the growth of the productivity of American labor. The costs fall on our children and our children's children more than on us. Our fiscal profligacy means that they will be able to produce and consume less.

The reason is that our rate of national saving and investment is pitifully and shamefully low. I refer to net rather than gross saving and investment and compare them to net rather than gross national product. The net figures exclude capital consumption, depreciation and obsolescence, which any prudent business or household would leave out in estimating its income and saving. National saving consists of nonfederal (household, business, state and local) saving plus federal saving (a negative number when the federal government is running a deficit).

Nonfederal net saving is roughly 6 percent of Net National Product nowadays; before this decade, the postwar norm was 8 to 9 percent. When federal dissaving of around 4 percent is subtracted, we have an overall national saving rate of 2 percent. The pre-1980 postwar norm was 8 percent. Domestic capital investment is down from 8 percent to 6 percent. It is as high as 6 percent, while national saving is only 2 percent, only because we have been borrowing 4 percent of NNP from foreigners.

Between 1978, a normal prosperous year, and 1987, real NNP (in 1982 prices) increased by $597 billion, 22 percent. Personal Consumption and Government Purchases rose by $736 billion, 29 percent. Real Net Domestic and Foreign Investment, the remaining major categories of uses of national product, actually declined. The increase in Personal Consumption alone was 94 percent of the increase in net output. In a similar comparison for the previous decade, Consumption took only 87 percent of a (larger) increase in output, and Consumption and Government Purchases combined only 91 percent, leaving 9 percent for net domestic and foreign investment.

I shall not rehearse the dreary international comparisons which show how low United States national saving and investment rates are relative to those of our major allies and competitors in Japan and Western Europe. Here is one dramatic figure to bear in mind: While U.S. and Japanese fiscal deficits are about the same proportions of Net National Product, ours takes nearly two thirds of the net saving of the rest of the economy, the Japanese only one fifth.

Our profligacy is depriving future Americans of tools and technologies that could augment their productivity, while saddling them with onerous obligations to foreign creditors and owners.

2. But isn't the deficit overstated?

There are various ways of calculating the deficit, and some of them would give lower figures in dollars. My friend Robert Eisner of Northwestern University is even able to find the federal government in surplus. He also defines private saving and investment in ways that increase their amounts.

I believe these questions of definition and measurement are mostly irrelevant to the issues of fiscal policy before the Congress, the President, and the people today. My reason is this: Whatever measure you use, there has been a big decline in both federal and national saving in the 1980s. Whatever measure you use, United States saving and investment is extremely low relative to other advanced capitalist democracies.

There may be merit in capital budgeting, although the treatment of land, military capital, and depreciation present formidable problems of estimation and interpretation. There is merit in inflation accounting, although recent experience can give us scant confidence that bondholders automatically save extra amounts to make up for erosion in the purchasing power of their bonds. But whatever merits there are, these same points had equal or greater merit before 1980. They cannot erase the fact that the federal government became much less thrifty, much more profligate, in the 1980s.

In one important way, the federal deficit is understated today. The "unified deficit", on which official attention is still focused, does not count the increase in Treasury obligations to social security beneficiaries. I shall return to this matter later.

3. The federal debt now is smaller relative to GNP than it was after World War II until 1963, but those were years of prosperity and rapid growth? If we could handle a debt of that magnitude then, why not now?

There are three big differences. First, in 1946-62 deficits were much smaller and the growth of GNP much greater. The debt/GNP ratio was steadily declining. In the 1980s, for the first time in peacetime, the ratio has been rising. Second, nonfederal savings were much more plentiful. There was lots of room in the economy for investment, without resorting to foreign borrowing. We had export surpluses; our overseas wealth was increasing. It is now declining. Third, interest rates, both nominal and real, were low. Service of the debt was a smaller burden, even though the debt itself was relatively bigger.

4. Why are interest rates higher now?

First let me just establish the fact that they are. As we have often been told, interest rates have come down dramatically in the 1980s. They were sky high in 1980, when the Federal Reserve, determined to subdue inflation, drastically restricted the supply of money and threw the economy into recession. That brief episode is not relevant to our analysis of fiscal policy. The revealing comparison is of real interest rates in the recovery 1983 to date and in previous business cycle recoveries. This is shown in Figure 1, where it is clear that the 1980s recovery stands apart, with outsize deficits and outsize real interest rates.

The mechanism is clear. The Federal Reserve has been trying to keep the economy on a track of non-inflationary economic growth. After the 1979-82 recessions, this meant growth of aggregate demand enough to keep up with the annual increases in the labor force and its productivity (together about 2.5 percent these days) plus enough to reduce unemployment and excess plant capacity at a prudent pace. Now that unemployment and excess capacity are close to their inflation-safe minima, that second, recovery, component of demand growth is no longer available. (For that reason, Reagan Administration budget projections that contemplate real GNP growth in excess of 3 percent, combined with 200 basis points declines in interest rates, are not credible.) In any case, since high-deficit fiscal policy has been contributing a big push to demand, via high defense spending and low taxes stimulating consumption, the Fed has had to keep interest rates high in order to avoid overheating the economy.

High interest rates feed back into higher deficits. That can turn into a vicious circle. If debt interest rates exceed the growth of the economy, the debt will grow faster than GNP even if the budget is balanced on non-interest transactions. Right now we are close to this threshold. With real growth confined to 2.5 percent and inflation at 5 percent, GNP in dollars can grow at 7.5 percent, about the same as the interest rate on government obligations net of taxes paid on such interest. By the same token, substantive cuts in the deficit would be rewarded by a bonus in savings of debt interest. Contrary to wishful thinking we sometimes hear, the bonus has to be earned by tax increases or cuts in non-interest expenditures.

5. Would cutting the deficit now cause recession?

No, it certainly need not have that result. Given reasonable notice, the Fed can offset with lower interest rates withdrawals of demand due to budget cuts or tax increases. New demand would come from domestic investment and from greater exports and/or lower imports. Improvements in the trade balance may already be in the cards, lagged responses to the substantial declines in the dollar since 1985. Eventual trade balance will probably require further dollar depreciation, which could be a natural result of the reductions in U.S. interest rates that would be the welcome by-product of serious deficit reduction.

The economy and its helmsman, Alan Greenspan at the Fed, face greater hazards if nothing is done about the deficit. Given the low dollar and the possibility that markets will push it lower, production of exports and import-competing goods should be increasing. Given the high degree of capacity utilization, domestic investment should be strong. But now there is not much room in the economy for these desirable claims on resources. In the absence of fiscal measures to lower private and public consumption, the Fed is likely to see overheating and inflation as the principal danger. Monetary restriction, if overdone, could lead to high interest rates, recession, and an uncompetitively appreciated dollar. Our adjustment to the imbalances of the 1980s would be further postponed.

6. Do we need new taxes?

Yes, definitely, in my opinion. I say Yes for two reasons. One is to lower the deficit. The other is to finance essential and desirable expenditures not now in the budget.

It is still unreasonable to count on growing out of the deficit. The "total deficit" for fiscal year 1989 is projected by CBO to be 3 percent of GNP. Even if real outlays (inclusive of interest) are held to increases of 2 percent per year while real revenues and GNP grow at the economy's sustainable rate of 2.5 percent, the deficit/GNP ratio will decline only by one tenth of a percentage point per year.

It is especially unreasonable in view of the compelling new claims on the budget now being recognized: the rescue of FSLIC, the repair of nuclear weapons facilities, deferred maintenance and expansion of the nation's infrastructure in transportation and public health, education from infancy to graduate training and research, the "war" on drugs, day care, the homeless and the shortage of low-cost housing, welfare reform and provision of the associated jobs and training, rehabilitation of pathological urban neighborhoods, foreign policy, environmental protection, health insurance, and so on.

It is true that 1988 federal revenues, in total, are the same percentage of GNP (19) as in 1979, and total outlays (22.3) are 1.7 percentage points higher. The compositions of both sides of the budget have changed drastically. Social security tax revenues have increased 1.3 points, while regular income tax revenues have declined a like amount. Defense has increased 1.3 points, interest 1.5 points, entitlements 0.9 points. Leaving social security to one side, in 1979 the excess of regular income taxes over defense and interest outlays was 5 percent of GNP. In 1988 it was only 1 percent of GNP. Essentially, any excess of civilian discretionary spending over 1 percent of GNP now has to be met by borrowing. In fact such spending was 3.7 percent of GNP in 1988, down from 5.5 percent in 1979.

7. Should Social Security surpluses be counted as deficit reductions?

The Social Security surplus, officially called "off-budget," is projected by CBO to be $56 billion (1 percent of GNP) this fiscal year and to rise to $68 billion in FY 1990 and to $117 billion (1.6 percent of GNP) in 1994. These figures include as off-budget revenues both payroll taxes and interest payments from the Treasury to the Old Age and Survivors Trust Fund, just as if the Fund were a nonfederal entity holding federal debt.

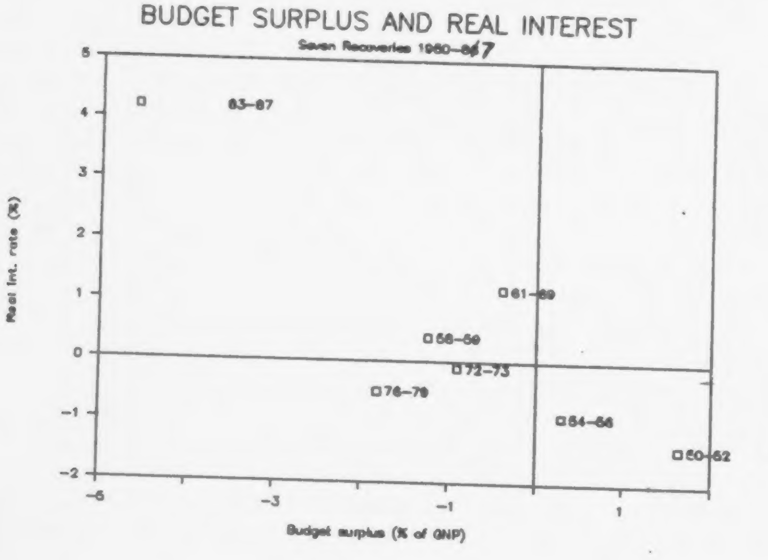
Clearly, if attention remains focused on the "total deficit," the growing Social Security surpluses make a big contribution to deficit reduction. But Congress had good reason to provide in the compromise legislation of 1983 for the growth of reserves in the Trust Fund, and likewise for moving the Trust Fund off budget.

In the past retirement insurance benefits were met on a pay-as-you-go basis from the contemporaneous revenues of payroll taxes. The big demographic changes now anticipated will reduce the number of workers per retiree from 5 in the 1960s to 2 in the middle of the next century. The reserves in the Trust Fund, both interest and principal, will enable benefits to be paid until 2060 in spite of the decline in the number of contributing active workers.

For this solution to work in the real economy, not just on paper, it is necessary that the nation save extra amounts and invest them in extra productive capital yielding the returns that will be credited as interest to the Trust Funds for the benefits of future retirees. That will not happen unless Congress and President firmly resolve not to use the Social Security surpluses as an excuse for higher "on-budget" deficits. The debt to the Trust Fund must be regarded as debt to the general public. Federal fiscal policy should see to it that federal debt, including debt to the Social Security Trust Funds, will in future be declining relative to GNP.

At the beginning I argued that the saving of this nation is woefully low, in relation to the nation's needs and to the obligations of present generations of Americans to their successors. The demographic transition and its implications for Social Security are a special addition to our saving requirements. The Trust Fund surpluses are a way of meeting that additional need, not a way of ameliorating the shortage of saving due to the declines in nonfederal and federal saving rates during this decade.

FIGURE 1



Chairman Rostenkowski. Thank you, Dr. Tobin. Dr. Summers.

STATEMENT OF LAWRENCE H. SUMMERS, PH.D., PROFESSOR, DEPARTMENT OF ECONOMICS, HARVARD UNIVERSITY, CAMBRIDGE, MASSACHUSETTS

Mr. Summers. Thank you very much, Mr. Chairman. My friend, Jim Tobin, had the good judgment to give my wife an A in macroeconomics when she took his course 10 years ago. I thought he got it right then, and I think he got it right just now, in the testimony that he gave. Some part of my testimony states somewhat differently, conclusions very similar to his.

I want to make four points in my testimony. First, the deficit problem is larger than it appears on the basis of either adminstration or Congressional Budget Office projections.

I get a sense of deja vu when I contemplate the administration's economic growth projection. The administration projects that the budget deficit will decline to $9 billion by 1994.

That forecast relies on the premise that GNP growth will continue at a 3.2 percent rate for the next 5 years, without interruption, with slowing inflation. That forecast I think people would regard as being at the outer edge of conceivable.

That projection also relies on the premise that the Treasury bill interest rate will decline to 3 percent and that the inflation rate will decline to below 2 percent. That projection, too, I think would be regarded as the outer edge of conceivable.

The possibility that both of these projections will occur, that the economy will boom, and that disinflation will proceed at a rapid rate, strikes me as simply ludicrous.

It would be most unfortunate if the Bush administration, or if the Congress, in their budget deliberations, were to make plans on the basis of forecasts of this kind, because it would send a signal about the kind of seriousness with which the problem is being taken.

Even the forecast of the Congressional Budget Office probably understates the magnitude of the problem with its projection that the deficit will decline slowly over the next few years to $122 billion in 1994.

It understates the problem because the CBO forecast is itself for more rapid growth than most private forecasters look for over the next 2 years, and it understates the problem because the CBO is rather optimistic about the likely path of interest rates.

More fundamentally though, the conventional view of the deficit problem is, as revealed for example, in the CBO forecast, understates its magnitude for reasons that Professor Tobin stressed.

First, no allowance is made for any of the new spending that is almost inevitably an orphan for the 1990 Census, for the savings and loan problem, for the efforts to make America a kinder and gentler place.

Second, most of the progress that has been made in the last several years, and all of the progress that is in prospect represents the ongoing use of the Social Security trust funds for the purpose of deficit reduction. Without that reliance on the Social Security trust funds, the budget deficit would be increasing and would be increasing towards $250 billion in the mid 1990's.

Third, there is the reality that what we ultimately care about is how much we as a nation consume, or how much we as a nation save. Because consumers are spending more of their incomes than they used to, because corporations are retaining fewer earnings than they used to, even if we were to have a balanced budget in the early 1990's, we would still be saving far less than we did as a nation in the 1950's, 1960's or 1970's.

It is not just hypothetical to suggest that the estimates that we are using understate the magnitude of the problem. The Congressional Budget Office has gone back and reviewed the budget estimates that were contained in the first budget resolution of the Congress over the last 8 years. Obviously, there were some changes in congressional intent about what programs were legislated. But if one simply looks at the economic and the technical assumptions contained in those budget estimated, they have proved to be too low, too optimistic by an average of $35 billion over the last 8 years.

No similar exercise has been performed by a long-term forecast, but were such an exercise to be performed, it would suggest, I believe, even larger errors.

So I suggest to you that there is still a big problem before us, a problem whose dimensions are very frequently understated.

Second conclusion: The budget deficits remain a serious national problem. There are three different, but I think related, problems with our substantial budget deficits and associated low level of national savings.

First, as Jim Tobin stressed, it reduces the growth in our standards of living. As a nation, the United States, over the last 3 years, has consumed 97½ cents out of every dollar that we have earned. We have saved only 2½ cents. That confronts the economy with a cruel dilemma. Either we can invest only 2½ percent of GNP, a rate of investment that would be a one-sixth of the Japanese rate of investment. Or we can invest, as we have, at a slightly greater rate, by borrowing substantially from abroad. And when we borrow substantially from abroad, running the large trade deficits that we have seen in the last few years.

In either event, the economy has not accumulated wealth for Americans. If we don't borrow, it's not accumulated wealth at all. If we do borrow, we're accumulating wealth, but the wealth is not owned by Americans.

Failing to accumulate, failing to provide for the future inevitably means slower rates or growth.

If you look at the figure that is about halfway through my testimony, preceding page 10, you can see that the United States does not occupy a position of honor in that graph. We have not been investing and, as a consequence, we have had slower productivity growth and slower improvements in living standards than the nations we compete with.

Everyone knows that we have lagged Japan in growth over the last 15 years. It is, I believe, more sobering to realize that the United Kingdom has significantly outperformed us over that same period.

The first problem then is that if we don't start saving more, running smaller deficits, we sacrifice growth in standards of living.

The second problem is that the risk of near term instability is greatly increased. Anyone who tells you they know where the exchange rate is going to go is wrong. Nobody knows where the exchange rate is going to go, and nobody can predict sharp financial dislocations of the kind we saw in October of 1987.

But it doesn't take a lot of imagination to realize that, as our debts accumulate, as foreigners hold more and more American paper assets, the risks that at some point they will lose confidence, they will come to believe the projections of those like my Harvard colleague, Martin Feldstein, that the deficit exchange trade will soon reach 100 yen to the dollar. And if they come to believe that, they will decide that they don't want to hold dollar assets. They will all try to sell dollar assets, and the prediction will prove to be self-fulfilling.

No one can say when that crisis will come or if that crisis will come. But it's not difficult to see that if our deficit is smaller, the risks of that crisis are significantly reduced.

The third reason why the budget deficit represents a serious problem is that it limits the Government's ability to respond to new challenges. We saw that yesterday in the decision to spend an extra $2 billion in interest in order to deal with the savings and loan problem in a way that showed up off the budget rather than on the budget. We see it in an ongoing way, in bridges that aren't repaired, in potholes that aren't repaired, in failure to spend money that would pay off over a small number of years to increase enforcement to the tax systems, give the Social Security Administration even remotely modern computers.

The pressure of budget deficits makes it difficult for the Government to plan rationally and to respond to new challenges. Those are the reasons why the budget deficit represents a serious problem.

Let me turn, third, to policy and the budget deficit. In my view, there is no realistic prospect that the flexible freeze approach of not raising taxes and not touching spending in the interest of defense and Social Security areas has any prospect of balancing the budget by the mid-1990's.

Projections, to the contrary, are based on the kind of optimistic assumptions that I criticized a little bit earlier. It is simply not realistic to think that the 20 percent cut in the rest of the Government budget that would be required to make the flexible freeze work is going to happen.

The question then of how the budget deficit should be reduced is really one of values than it is of economics. And I can't speak to what the appropriate size of the defense budget is. It is a question of values, what one feels about the desirability of maintaining Social Security benefits.

That brings us to the question of revenues. And in my testimony I argue that the supply-side economists of the early 1980's were right to emphasize that taxes do have incentive effects. But they were, I think, wrong in failing to appreciate that there are incentive effects of taxes that can be desirable. There are activities that can be discouraged while, at the same time, raising revenue and contributing to economic efficiency. And in the testimony, starting on page 14, I list a variety of tax increases that would maintain progressivity, raise 50 or more billion dollars, and have incentive effects that would, in my view, work almost entirely in the direction of making the United States more and not less competitive. I can return to those items in the question period.

Finally, the fourth conclusion is that the national saving problem will remain even if we balance the budget. Even if the Federal Government were balanced, the budget were balanced, the United States would still, in the early 1990's, be saving somewhere between 5 and 6 percent of its GNP. That is a saving rate that is a third of the Japanese saving rate, and is half of the saving rate of the average of the OECD countries with whom we compete. And that's a saving rate that will make it difficult for us to enjoy rapid productivity growth.

That means we have got to go beyond balancing the budget. One possibility is running Federal budget surpluses. I hope we do that. I don't expect to see us running Federal budgetary surpluses.

A second approach is to, as Professor Tobin stressed, put the Social Security budget off-budget, and endeavor to balance the remainder of the budget so that the Social Security system can make a positive contribution to increasing national saving.

A third approach is to work to increase private saving. It is my view that, in the overall desirable 1986 Tax Reform Act, the Congress erred in eliminating the full use of IRA provisions. The weight of the evidence, I believe, suggests that a very substantial fraction of the nearly $25 billion a year—$45 billion a year that flowed into IRA's represented new saving, saving that would not otherwise have taken place, and then especially now, when interest deductibility has been limited, it would be appropriate overtime to move towards the restoration of those IRA accounts.

Further progress in increasing national saving could be found by encouraging employers to provide employees with deferred compensation, perhaps in the form of equity in the enterprises for which they are worth, and perhaps by increasing corporate saving by limiting the kinds of extremes of corporate borrowing that we have seen in the last several years.

I would just conclude by saying that warnings about the consequences of the deficit must grow wearisome, but the boy who cried wolf was, in the end, eaten by the wolf.

[The statement of Mr. Summers follows:]

The Budget Deficit Problem: 1989

Lawrence H. Summers
Harvard University

I am pleased to have the opportunity to testify before this distinguished committee on the continuing problem of the American budget deficit. This committee has now been taking testimony on the budget deficit problem for the better part of a decade, and so it is difficult to say anything new about its severity or about possible solutions. There is however much that has been said in the past that remains true today, even as many grow weary of the deficit problem and urge policymakers to focus their energies elsewhere. In my testimony today, I want to highlight the continuing seriousness of the deficit problem, and offer some observations about possible solutions. More specifically, I shall make four primary points.

First, the budget deficit problem remains the most serious obstacle to the maintenance of steady and rapid economic growth over the next 5 years. The Administration budget forecasts are ludicrously optimistic. While the Administration growth forecast, and the Administration interest rate forecast are individually conceivable, it is inconceivable that growth will increase and interest rates will decline in the way the Administration forecasts. Even the forecasts of the CBO are more likely to err on the side of optimism than pessimism. Furthermore, despite reductions in budget deficits, the national saving rate has declined over the past 5 years and is now at record low levels based on either historical or international comparisons.

Second, continuing large budget deficits and low levels of national saving pose three primary risks. First, they will inevitably lead to slower growth in American productivity and standards of living. Increasingly, wealth created in the United States will not be deployed for the benefit of Americans. Second, continuing large deficits raise the risk of major disturbances in international financial markets—disturbances that would lead to increases in both American inflation and unemployment. Third, continuing large budget deficits will create a harsher, crueler and less competitive nation as Federal policymakers find it difficult or impossible to meet new challenges.

Third, the economic effects of budget deficit reduction depend very little on whether it occurs through spending cuts or revenue increases. Decisions about how to reduce the deficit should therefore be based on a comparison of the benefits of public spending with the costs of tax increases. The scope for spending cuts within a "flexible freeze" framework are limited given that Social Security, Defense, and interest which together comprise more than 60% of the budget are ruled off-limits. A number of possible tax increase measures would have desirable incentive effects.

Fourth, beyond budget deficit reduction, there is an urgent need for the Congress to consider other ways of increasing national saving. These might include preserving the integrity of the Social Security Trust funds by focusing attention on the non-Social Security deficit which is now projected to approach $250 billion in the mid 1990s, the restoration of tax incentives for individual saving, and measures which discouraged corporate dissaving by taxing corporate restructuring transactions more appropriately.

In the remainder of this testimony, I shall amplify on these points.

The Magnitude of the Deficit Problem

The appropriate policy response to the deficit problem depends on its magnitude and on its likely evolution if no policy actions are taken. For reasons that I shall explain more fully below, the crucial issue for the economy is less the level of the deficit in any given year, than it is the anticipated path of the deficit. On this crucial question, the Reagan Administration and CBO forecasts suggest quite different answers. The CBO foresees a budget deficit of $155 billion this year declining very slowly to $122 billion in 1994. The Administration on the other hand, forecasts rapid declines in budget deficits down to 9 billion dollars in 1994.

The outgoing Administration's forecasts should not be taken seriously in budgetary planning. If the new President and the Congress rely on these forecasts as they debate the budget, financial markets participants will conclude that there is no political consensus for meaningful action to resolve the budget deficit. The Administration's growth forecast of steady growth at 3.2 percent rate for the next 5 years is regarded by almost all private forecasters as excessive. Likewise the Administration forecast that inflation will fall below 2 percent, and interest rates will fall to 3 percent is regarded as far too optimistic. However almost every private sector expert regards it as all but inconceivable that the Administration's rapid growth forecast and its forecast of falling interest and inflation rates will come to pass.

Even the CBO's forecast probably understates the magnitude of the deficit problem. The CBO forecasts growth at a rate of 2.9 percent in 1989 and 2.2 percent in 1990. The Blue Chip consensus of 50 leading private sector forecasters looks for growth rates of 2.3 percent in 1989 and 1.9 percent in 1990. Moreover, few private experts would forecast as the CBO does that there will be no period of increasing unemployment anytime in the next 5 years or that interest rates will decline by close to 200 basis points even as the economy grows steadily.

Forecast errors have very large effects on budgetary projections. Consider the following facts. A sustained one percent increase in unemployment would raise the 1994 budget deficit by 77 billion dollars. A sustained one point increase in interest rates would raise the 1994 budget deficit by 29 billion dollars. These estimates imply that a recession much less severe than those experienced in 1975 and 1982 would raise the budget deficit by more than 100 billion dollars. In my judgment the chances are better than 2 in 3 that the economy will go into recession in the next 4 years if nothing is done to bring the budget deficit under control.

History supports the conclusion that the economic estimates relied on by the Congress are too optimistic. Last year was typical. The one year ahead economic estimates in the Spring Congressional Budget Resolution proved to be too optimistic by $37 billion. This is just about equal to the average error made over the last 8 years. Especially if it relies on the Administration's economic assumptions, the Congress is likely to again this overestimate how much progress is being made in reducing budget deficits.

Beyond the problem of excessively optimistic forecasts, there are other reasons to expect that even the CBO forecasts understate the magnitude of the deficit problem. First, there is every reason to expect that at least some new spending will be legislated. There is nearly universal support for new spending to do something about the S&L crisis, nuclear wastes, education, and the environment. A variety of other spending initiatives were widely discussed during the Presidential and Congressional campaign.

Second, much of the progress that has been made in reducing the budget deficit and all of the progress in prospect in reducing the deficit comes from the contribution of the Social Security and other trust funds.

Without the contribution of the Social Security trust funds, the 1989 deficit would exceed $200 billion and the deficit would be on an increasing path over the next five years. If the Social Security trust funds are used to finance current budget deficits, they will not be available to help us prepare for the retirement of the baby boom generation. Furthermore, the use of the Social Security trust fund money to finance general spending obligations represents a major shift in the Federal revenue structure towards the relatively regressive payroll tax.

The Social Security point may be put in another less conventional way. Social Security represents a government liability. As we draw closer to the retirement of the baby boom generation, this liability is increasing rapidly. A private company facing a growing pension liability would have to subtract this liability from its profits, if it did not fund it. If the Federal government were held to a similar standard, the current deficit would be greatly increased.

Third, the budget deficit is important because of its impact on national saving. Despite the progress that the Federal government has made in reducing its budget deficit over the last several years, the level of national saving was below 2 percent in 1986 and 1987 and below 3 percent in 1988. As Table 1 illustrates, the national saving rate has been lower over the last 3 years than in any prior period in our history. This means that the pool of American funds available for investment is smaller relative to our income than ever before. If the goal of deficit reduction is to increase American investment or to reduce our dependence on foreign capital, the last few years have seen no improvement despite reductions in the reported deficit.

Table 1

National Saving and Investment (% of GNP)

Year	Net Private Saving	Federal Deficit	Net Investment	Current Account Deficit
1970-75	8.85	1.69	6.66	0.50
1976-80	8.55	1.90	6.68	-0.03
1981	7.75	2.09	5.49	0.17
1982	6.60	4.60	2.02	-0.03
1983	7.13	5.16	3.10	-1.13
1984	8.55	4.49	6.60	-2.55
1985	7.30	4.90	5.12	-2.72
1986	6.76	4.84	4.95	-3.03
1987	5.26	3.48	5.14	-3.36
1988	5.73	2.91	5.33	-2.52

Source: Data Resources, Inc. and National Income and Product Accounts

Excessive optimism in budget forecasts, the likelihood of new spending, the ongoing absorption of Social Security surpluses and then reality of unprecedentedly low national saving all suggest that the budget deficit situation remains serious.

Critics of this mainstream conclusion come from both ends of the political spectrum. Some "hard core" Keynesians most notably American Economic Association President Robert Eisner argue that the standard deficit measure is misleading because of its failure to recognize that some government expenditures represent investment, and its failure to take account of the fact that inflation erodes the real value of government debt. These points are arguable. It is not in dispute that the government's fiscal stance in the 1980s is far looser than in any other peacetime period in our history. Indeed, since public investment has plummeted during the 1980s, the deterioration in the Federal budget position is actually greater when measured using capital budgeting concepts than when measured in the standard way.

Nor do any of the accounting changes favored by Eisner address affect measures of the national saving rate. As long as the national saving rate is less than three percent, there is a clear case for policies to reduce Federal dissaving regardless of how the deficit is measured. This means reducing the gap between Federal spending and Federal tax collections.

Others, including Milton Friedman and a number of "supply side" economists suggest that deficits do not matter because the real burden of government activities is determined by the amount government spends not by the difference between spending and taxes. Proponents of this argument agree with the mainstream view that reductions in government spending would increase the pool of national saving and permit increases in investment without increased reliance on foreign borrowing. However, they question the mainstream view that increased tax collections would also increase the national saving rate by reducing government borrowing. Their argument for this proposition is the claim that deficits directly increase household saving because households recognize that in the future they will have to pay taxes to service the national debt and therefore save in anticipation of this possibility. As a consequence, they claim that if spending is kept constant, tax increases reduce private saving dollar for dollar.

This "Ricardian equivalence" view is supported by neither logic nor evidence. It is implausible that consumers look ahead to tax burdens their children may have to bear in the future in servicing the national debt. Moreover, many if not most households do essentially no saving aside from their pension plan and home and therefore are in no position to adjust saving as the government deficit changes. As a matter of evidence, the unprecedented increase in the budget deficit during the 1980s has coincided with a sharp decrease in private saving not the increase predicted by the Ricardians.

I conclude that an economically important and significant deficit problem remains. In all likelihood the budget figures used in current debates understate rather than overstating the magnitude of this problem.

Why Budget Deficits are Harmful

It is tempting in thinking about the costs of budget deficits to contrast their burden with the burden associated with spending reductions or tax increases. This is not right. Budget deficits are not an alternative to spending cuts or tax increases. Since the government must ultimately pay for everything it buys, they are only a means of postponing spending cuts or tax increases. Because interest accumulates, the difficulty of dealing with deficits only increases with delay.

There are several reasons why budget deficits represent a serious and continuing problem for the American economy. Each relates back to the fact that the deficit depresses our national saving rate, and causes us to substitute consumption for investment, and foreign capital for domestic capital in financing what investment does get done. As a nation, we consumed publicly and privately close to 98 cents out of every dollar of income we earned over the last several years. Our current national saving rate is one-third of the rate we enjoyed during the 1970s, when supply side concerns about inadequate saving began to emerge. It is about one-half the saving rate of Great Britain, one-fourth the average saving rate of the major industrialized countries, and one-sixth the saving rate of Japan.

First, continuing budget deficits and low national saving mean slow growth in American living standards and reduced American competitiveness. Low national saving is the primary cause of our current trade deficit. Nations like the United States that invest more than they save must borrow funds from abroad. The only way foreign funds can come into the United States is for Americans to import more than they export. The US current account deficit of 3.5 percent of GNP in 1987 arose because the United States saved only 2 percent of GNP but invested 5.5 percent of GNP. Japan, on the other hand with saving in excess of investment has enjoyed consistent trade surpluses.

Low national saving also results in low investment. The United States invested less, relative to GNP in plant and equipment during the 1980s than during the 1950s, 1960s, or 1970s. Capital labor ratios have grown less rapidly in the United States than in any of our major competitor nations with disastrous consequences for living standards. Japanese workers have gained ground at 6% a year relative to their American counterparts over the last 15 years as American real wages and family incomes have remained essentially stagnant.

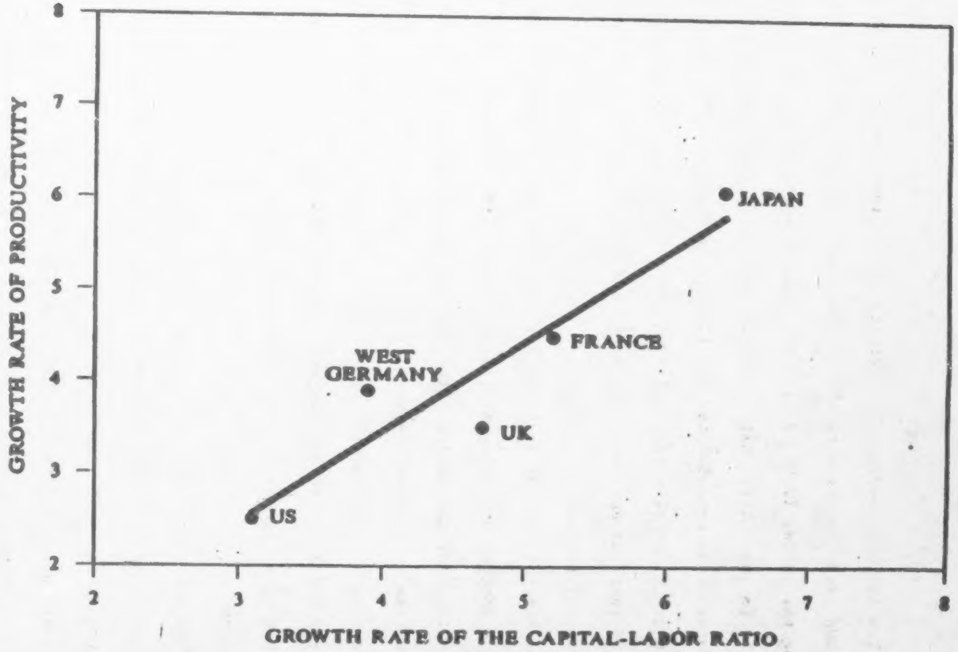
Low national saving leads to reduced investment because it raises the cost of capital by making it scarce. High costs of capital are an important explanation for the myopia often thought to afflict American businessmen. An American businessman, given his costs of capital would be willing to invest only $.37 in return for a dollar six years from now, compared with $.66 for his Japanese counterpart. It is hardly surprising that Japanese managers often appear to take a longer view than their American counterparts.

The combined effect of reduced investment and the foreign financing of a large fraction of what investment does take place is to gradually reduce relative American living standards. This is not something that occurs overnight but as Figure 1 illustrates, there is a clear relationship between national saving rates and rates of growth. The United States is a wealthy nation and so it can finance a high rate consumption by selling off assets for a long time—but not for ever. Unless, our national saving rate is restored at least to its former level in the 7 percent range it is very likely that we will be overtaken by a number of our competitor nations in the next few years.

FIGURE 1

PRODUCTIVITY VS. THE CAPITAL-LABOR RATIO IN MANUFACTURING

(AVERAGE ANNUAL GROWTH RATES, 1970-1986)



Sources: U.S. Department of Labor, Bureau of Labor Statistics
U.S. Department of Commerce, Bureau of Economic Analysis
Organization for Economic Cooperation and Development

The second problem with large Federal deficits and low rates of national saving is that by causing the US to experience large capital inflows they increase the risks of severe financial disruptions. As long as large Federal deficits continue, the Federal Reserve will have an extremely difficult time in keeping the economy on an even keel. On the one hand, there is the risk that large deficits and robust consumption spending will threaten to overheat the economy forcing the Federal Reserve to jack up interest rates in an effort to head off inflation. This could lead to a repeat of the situation in the early 1980s when a collision between fiscal and monetary policy drove real interest rates way up, caused the dollar to soar hurting the competitiveness of US producers, and leading to a recession. Already, the collision between monetary and fiscal policy has pushed the real value of the dollar up about 10% from its level at the end of 1987.

While there is considerable controversy about what exchange rate adjustments are will eventually be necessary if US trade is to be balanced, there is little argument for allowing the dollar to increase sharply at the present time. A strong dollar would after a short adjustment period significantly increase the US trade deficit, leading eventually to a the need for a major dollar depreciation when foreigners recognized that the US international position was not sustainable. Indeed, if budget deficits remain large, it is difficult to predict the timing of the dollar's fluctuations. It is possible that foreigners will lose confidence in the dollar especially if the Federal Reserve shows signs of being willing to tolerate inflation. In this case, the dollar could fall rapidly causing US interest rates to spike, and leading to a period of stagflation as reduced credit availability led to recession and a weak dollar pushed inflation upwards.

So far, the economy has avoided lurching towards either a surging dollar or a plummeting dollar path. But as long as budget deficits remain the possibility of serious instability will continue. Foreign exchange markets are notoriously volatile. If they conclude either that a renewed outbreak of American inflation is likely or that a period of tight money and high interest rates is likely, the value of the dollar could move very far very fast creating nearly impossible dilemmas for economic policymakers.

The third problem with budget deficits is that they make it nearly impossible for the Federal government to respond rationally to new policy problems. The S&L debacle is a good example of the consequences of shoestring budgeting. The deficit induced unwillingness to spend Federal money has greatly increased the government's ultimate liability. The obsolete computer system used mail out Social Security checks, the nearly 50% reduction in Federal infrastructure investment during the 1980s, and the President elect's recent statement that budget priorities needed to shape our strategy for fighting drugs all serve to illustrate how difficult it is to make policy rationally when money is so tight.

The effects of leveraging companies to the hilt as done in recent LBOs have been much discussed in recent years. The point is often made that high levels of leverage puts pressure on companies to cut out fat but also leads them to be very present oriented. As the example above illustrates, the Federal government is now in a similar situation.

How serious have these costs of budget deficits been so far? The following statistic seems revealing. In 1981, the combined value of all the companies on the American stock market was more than 50% greater than the combined value of all the companies on the Japanese stock market. Today, the combined value of Japanese companies is more than 50% greater than the combined value of American companies despite the fact that Japan has only half the population of the United States. Markets look forward not backwards and so this has to be an ominous sign.

Policy and the Budget Deficit

It should be clear from the preceding discussion that reductions in budget deficits will contribute to long term growth, short run stability and public investment regardless of whether they are achieved through spending cuts or tax increases. In either case, the supply of national saving to finance investment will be increased. The only difference between the two strategies is that reductions in government spending reduce public consumption while reductions in transfer payments or increases in taxes reduce private consumption.

The tradeoff between the benefits of private and public consumption is not an economic question. But economic analysis can help to assess the magnitude of the spending reductions that are feasible over the next several years. Unfortunately, rhetoric about flexible freezes not withstanding the scope for spending reductions in coming years appears minimal unless current political attitudes towards defense and Social Security are altered.

The critical thing to understand about the flexible freeze proposal is that the condition that real spending remain stable does not mean that benefit levels under existing programs can be kept constant. Because our population is growing, there will be more beneficiaries of almost every government program next year than there were this year. Furthermore, many of the things the government buys, medical care and weapons for example, have costs which normally rise faster than the overall rate of inflation. Hence implementing the flexible freeze will require significant cutbacks in existing programs even if no new initiatives are undertaken.

Can the flexible freeze approach be made to work? The recent budget estimates of the CBO suggest not. These estimates (which as I have already noted are rather optimistic) imply that if Social Security is not touched, interest payments are not reduced, and defense spending which has already declined by 11 percent in real terms since 1985, is kept constant, the $122 billion spending reduction required to balance the 1994 budget would represent about a 20 percent reduction in the rest of the budget. This means everything from the National Parks to the National Science Foundation, from the FBI to the FDA, from Medicare to programs for poor mothers and their infants. Cuts of this magnitude are not politically realistic for the very good reason that they would hurt those who have already suffered most during the Reagan years, and interfere with public investments that are needed if we are to restore the competitiveness of our economy.

Some proponents of the flexible freeze approach to deficit reduction argue that such large reductions in spending are not required because the flexible freeze program would reassure financial markets and cause interest rates to decline. Just how credible the financial markets would find the freeze plan is open to question. But even granting this point the argument is dubious since the CBO forecast already builds in a decline of nearly 2 percentage points in the level of interest rates. Furthermore, flexible freeze arithmetic suffers from the same problems as standard budgetary projections in taking no account of new spending, the likelihood of a recession sometime in the next five years, and the ongoing use of the Social Security trust funds to finance current government spending.

The reality is that there is no appreciable chance of balancing the budget by 1994 without some combination of reduced real defense spending, reductions in Social Security benefits and increased tax collections. While it is true that the Federal budget was rarely balanced even prior to 1980, it is also true that even a balanced Federal budget in 1994 is likely to mean a national saving rate lower than the United States experienced cyclically normal period prior to 1980. Declining private saving, an aging population, and increasing competitive challenges from the rest of the world are all reasons why the United States should target a balanced unified budget for the Federal government by the early 1990s and a surplus thereafter.

I leave to others the question of the desirability and feasibility of reducing defense spending and/or cutting defense spending. If these options are rejected, I believe that a package of tax measures can be crafted that would meet the objectives of (i) having desirable incentive effects on economic behavior (ii) raising $50 billion or more each year (iii) increasing American competitiveness and spurring investment and (iv) not tampering with changes made in the 1966 Tax Reform Act (v) increasing the progressivity of the tax system.

A package of tax measures that meets these five criteria could include some of the following items:

* Restoring taxes on cigarettes and distilled spirits to their 1952 level (in real terms) and equalizing the tax rates on alchoholic beverages.

These taxes would raise more than $10 billion a year. Increased alcohol and cigarette taxes would also avert thousands of deaths each year, and save employers billions of dollars in insurance and absenteeism costs.

* Requiring firms to amortize their advertising outlays. Since annual advertising spending by U.S. corporations totals approximately 75 billion, this policy would raise up to $10 billion a year over the next several years. It would also reduce the current tax bias towards promotional outlays and away from productivity enhancing new investments in plant and equipment. It is hard to understand why hiring Michael Jackson to promote a product or taking an ad out on the op-ed page of the New York Times should receive more favorable tax treatment than productivity enhancing investments in new plant and equipment.

* Taxing short term turnover on financial markets. Alone among the major industrialized nations, the United States does not tax the transfer of corporate stocks and other financial securities. Transactions taxes raised nearly $13 billion in Japan last year. Taxing turnover on financial markets would discourage speculative turnover that can create instability, and does shorten managerial horizons, and divert resources into the zero sum game of seeking to predict short term market movements. A tax of .5 percent on stock market transactions along with similar taxes on other markets would raise more than $10 billion a year from those who can afford to pay.

* Increasing the gasoline excise tax by ten cents per gallon. This would raise $9 billion a year and also encourage energy conservation. Unlike a general oil import fee it would not burden the many companies that use energy products as an intermediate good in their production.

* Imposing taxes on portfolio income earned in the United States by foreigners. This could raise about $5 billion a year and at the same time promote U.S. competitiveness by reducing our dependence on foreign capital. It is inequitable that American families pay more taxes on their saving accounts in American banks than foreigners do on their million dollar certificates of deposit. Tax rules that may have been appropriate when we were a major creditor are becoming need to be rethought in an era when the United States will be a major debtor nation.

* Tightening the enforcement of existing tax laws. While the revenue yield from increased enforcement may have been exaggerated during the recent Presidential campaign,t here is little doubt that increases in the Internal Revenue Service budget are repaid many times over with increased revenues. The audit rate today is well below its level 20 years ago, and so it is unlikely that significant increases in enforcement efforts would represent severe harassment of taxpayers. Since there is almost perfect tax compliance on wage income because of witholding, this revenue increasing strategy would raise the progressivity of the tax system.

* Taxing Cadillac employer provided health plans. There are strong reasons for tax subsidies that encourage employers to provide their workers with health insurance. But the most generous health care plans increase

demand and fuel health care inflation by eliminating incentives for patients and providers to be cost conscious. Eliminating the tax subsidy on health insurance above a certain ceiling would affect only a small minority of the population, but contribute to reduced health care costs, and raise several billion dollars in tax revenues. It is noteworthy that the Reagan administration prosed reforms along these lines and made it explicit that they represent "health policy" not "tax policy".

* Limiting the deductibility of corporate interest. Every dollar corporations borrow costs the Federal treasury close to 25 cents because corporate borrowers deduct interest payments at a much higher tax rate than corporate lenders are taxed at. Whatever the merits or demerits of LBO's and similar financial transactions, there is no case for subsidizing the use of debt finance. Reasonable limits on interest deductibility would raise several billions of dollars a year without burdening growing companies.

The supply side movement of the early 1980s was right to stress that taxes have important incentive effects. But it is now time to recognize that there are tax increase measures that would have desirable incentive effects even if we had no budget deficit. When and if the Congress turns too new revenues in an effort to reduce the budget deficit they deserve consideration prior to moves towards a major new value-added tax or to raise income tax rates.

Raising Private Saving

The fundamental problems faced by the American economy involve its low level of national saving. While there can be no question but that reducing Federal deficits is the most potent and reliable way of increasing the national saving rate in both the short and long run, there is some scope for other policies to affect the level of national saving.

First, Social Security should be removed from the official budget in order that trust fund surpluses can contribute to increased national saving. These surpluses, which will exceed $100 billion by 1993 must be accumulated in order to meet the needs of the baby boom cohort when it retires. If the trust fund is used to reduce the government deficit it will not be there when it is needed. From a political perspective, moving Social Security off budget will both protect Social Security benefits and increase the pressure for deficit reduction measures by raising the apparent size of the deficit problem.

Second, the "bully pulpit" function of the Presidency should be brought to bear on the problem of inadequate private saving much as it was successfully used to encourage energy conservation. New tangible incentives to saving and disincentives to borrowing should be matched by rhetorical emphasis on the need for increased saving.

While the 1986 Tax Reform Act increased economic efficiency in many ways, the partial revocation of IRA's was unfortunate. because the widespread conviction that IRA's are ineffective in stimulating savings is not supported by the available evidence. While the officially measured personal savings rate has declined since 1981, this should not be taken as evidence that IRAs do not have a substantial impact on savings decisions. Many other factors affecting the savings rate have changed since 1981, so that any positive effect IRA's might have had has been masked. Reduced corporate pension contributions, increased consumer borrowing, and renewed consumer confidence are all possible explanations for the low savings rate. Without the enactment of IRAs, the savings rate might well have fallen even further.

While naive before and after comparisons do not shed much light on the incentive effects of IRAs, other evidence strongly suggests that they have a significant impact on savings. Perhaps the most direct evidence on the question of whether IRA savings represent incremental savings comes from direct surveys of savers. Respondents in the Federal Reserve's Survey of Consumer Finances were asked whether they made IRA contributions and a variety of other questions about their financial affairs. David Wise of Harvard's Kennedy School of Government and Steven Venti of Dartmouth College have conducted a careful statistical analysis of these data on the basis of which they conclude that about half of the money flowing into IRA's represents new savings, about thirty percent of the money comes from the taxes individuals save by making IRA contributions, and only about 20 percent of the money comes from savings that would have taken place anyway had their been no IRAs.

Further evidence that many IRA contributions represent incremental savings is provided by the behavior of IRA contributors. An individual can maximize his tax advantage from making use of an IRA by contributing as early as possible, in January of each tax year. Presumably taxpayers who were simply shifting assets that were being saved anyway would make their IRA contributions early in the tax year. On the other hand, persons for whom IRA contributions represent new savings may not have funds on hand to contribute early in the tax year. Those who contribute late are likely to be contributing new savings, either because it took time to generate them or because they are responding to advertising blitz that financial institutions put on every March and April. IRS statistics reveal that some $15 billion or 45 percent of 1984 IRA contributions were actually made in 1985 suggesting that a significant amount of new savings were generated by IRA contributions.

It is important to recognize that tax policies do not affect economic behavior only by altering incentives. They also work indirectly by changing public attitudes and providing incentives for firms to engage in persuasive advertising of a kind they would otherwise not engage in. The existence of IRAs may cause people to focus more on the need to save for their retirement than they otherwise would. They certainly give banks and other financial institutions a strong incentive to remind people of the need to save for retirement. Some suggestive evidence on the long term importance of these effects along with the incentive effects of tax provisions comes from Canada which put a retirement savings program like our IRA program into effect in 1972 and significantly liberalized it in 1976. As Figure 2 illustrates, the savings rate in Canada which had closely tracked that of the United States took off soon after the 1976 liberalization and has exceeded ours ever since.

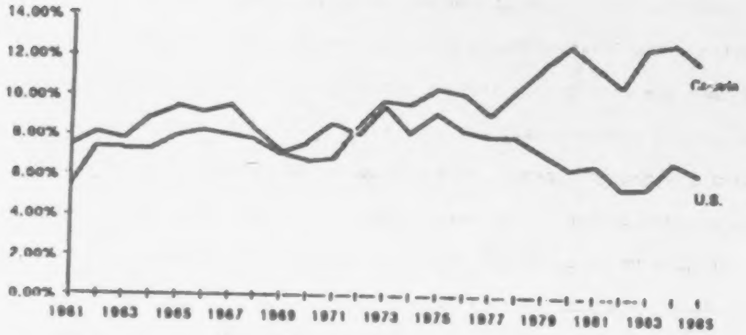
The weight of the available evidence suggests that IRAs generate a significant amount of saving that would not otherwise have taken place. Under current law, if IRA's were reinstated, the government would lose about 25 cents for each dollar of contribution. If more than one fourth of the money contributed to IRAs represents new savings, they will increase private savings by more than their revenue cost. If this condition is met, the case for maintaining IRAs is clear. Even if it is not, there is still a strong case for savings incentives given that restoration of IRAs would be likely to come at the expense of other tax breaks rather than larger deficits.

Limitations on corporate financial restructuring would probably also increase national saving by raising corporate retained earnings and reducing payouts to shareholders. Leveraged buyouts leave firms in a position to do no corporate saving because cash flows are exhausted by interest payments and dividends. Share repurchases have also substituted private consumption for corporate saving. Corporate restructuring in which pension fund assets have been used to finance acquisitions have had particularly pernicious effects on national saving and should be curtailed.

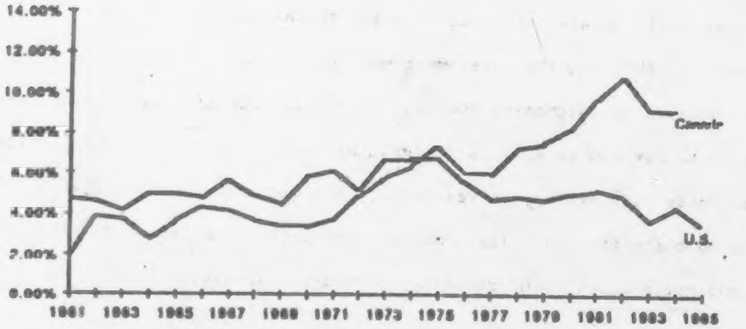
Consideration should also be given to new tax incentives for deferred employee compensation. Employees accepting compensation in the form of stock

Figure 2

Private Saving Rates as a Percentage of GNP



Personal Saving Rates as a Percentage of GNP



Source: Chris Carroll and Lawrence Summers, Why Have Private Savings Rates in the United States and Canada Diverged?

that could not be sold for five years, or special treasury notes that could not be sold would receive a partial tax deduction of perhaps 25% of their compensation. The Treasury would lose revenue only to the extent that people actually made the decision to save by deferring their compensation. Assuming that the typical taxpayer paid tax at a rate of 20%, the program would only cost the Federal government 5 cents for every dollar of extra saving generated. By appropriate manipulation of the withholding rules, employers could be given a strong incentive to sell the saving incentive to their workers, even in case where companies were not publicly traded.

These ideas represent just a few of the many possible strategies that could be used to increase private saving. They are a complement not a substitute for a strategy of Federal deficit reduction. It would not be desirable to adopt tax measures that cost revenue in order to raise the private saving rate except as part of packages that were overall revenue neutral.

Conclusion

Budget deficits are not an alternative to painful spending cuts or tax increases. In the end, the government must pay for everything it buys. They are only a means of postponing the pain of cutting spending or raising taxes. It is hard to see how we as a nation gain by postponing painful but inevitable choices. These warnings may be wearisome. But one must remember that in the end, the wolf ate the boy. Its time to discard the premises of the flexible freeze and get serious about reducing the budget deficit.

Mr. GIBBONS [presiding]. Thank you, Dr. Summers. We hope that that doesn't happen here, but it could.

Mr. Miller, we are glad to have you here. We welcome you back and look forward to hearing you.

STATEMENT OF HON. JAMES C. MILLER III, PH.D., JOHN M. OLIN DISTINGUISHED FELLOW, CITIZENS FOR A SOUND ECONOMY, FORMER DIRECTOR OF THE OFFICE OF MANAGEMENT AND BUDGET

Mr. MILLER. Good to be with you. I'm in different garb this time.

Mr. GIBBONS. Well, we appreciate your being here.

Mr. MILLER. As you know, I served as the President's Budget Director for 3 years, and since that time I have held concurrent positions as John M. Olin Distinguished Fellow at Citizens for a Sound Economy Foundation, and also at George Mason University's Center the Study of Public Choice. Also, I was recently elected chairman of the Board of Citizens for a Sound Economy, which, as you probably know, is a 250,000 member grassroots organization committed to fiscal discipline and integrity, among other things.

I am very glad to be here with you this afternoon. I appreciate the opportunity of appearing before the committee, and especially in such stellar company as my colleagues here on the witness stand.

The economy in general is in very good shape. We have just ended 6 years of expansion. That expansion should continue. It is a fairly balanced expansion. It is export led to some extent. I believe interest rates will moderate in the short run. The real growth that we had last year increased aggregate supply quite substantially even to offset the increase in aggregate demand. So there was less pressure on prices that many had assumed.

As there is a reduction in the uncertainty over President Bush's economic policies and what the Congress is going to do about the deficit, I think we'll see a squeezing of real interest rates, and this will bring nominal interest rates down.

On the employment sphere, total employment should continue to grow. Labor force participation rates will continue to rise. Unemployment rates will remain low. The trade deficit is on the way down. The data show this primarily because there has been an appreciation of foreign currencies relative to the dollar. That's the way we used to say it in the administration. Some people call it a fall of the dollar. Because of the J-curve, all of the effects of this change in relative prices have not been wrung out of the economy. And we may see some further fall in the dollar though I don't expect it to be very large.

There is reason to be optimistic about the economy, but we could find some things that could be very troublesome for the economy. If the Federal Reserve were to restrain significant growth in the monetary aggregates; if people had a perception that we'd abandon our attempt to reduce the deficit; if Congress passed a substantial increase in the minimum wage; if it passed widespread so-called mandated benefits; if it passed protectionist trade legislation, or if we had just a spat of bad luck, the economy could go sour.

Now, let me, if I might, speak a little bit about the deficit. My colleagues here talked about the deficit in their remarks, and I do have substantial disagreements with some of the statements they have made. And I'd be glad to get into colloquy with them at the appropriate time.

The first thing to remember when we talk about the deficit is that we've made substantial progress. The deficit was $221 billion in fiscal year 1986. It came down to $150 billion in fiscal year 1987, and let me put the caveat in right now that we include the Social Security surplus in that figure. And for reasons I will explain at some appropriate time, I tend to agree with my colleagues here about the Social Security surplus.

In fiscal year 1988, however, the deficit went back up to $155 billion. It's projected to be $161 bilion for fiscal year 1989. And under the Reagan budget, it would be $92 billion in fiscal year 1990.

As a proportion of gross national product, however, the deficit was at 5.3 for 1986, 3.4 for 1987, 3.2 for the last 2 years, and projected to be 1.7 under the Reagan budget. Now, whether you agree with the Reagan budget or don't, keep in mind that the $92 billion figure is just below the Gramm-Rudman-Hollings target of $100 billion. If you are going to hit that target, the deficit will be less than 2 percent of gross national product.

Now, on the other hand, I believe that deficits do matter. Overall, deficits restrain economic growth. And, secondly, there's a moral or an ethical dimension to the deficit that has received scant attention of late—and that is because there is fiscal illusion, we tend to burden future generations.

The most important thing I think we could do in terms of dealing with the deficit is for all of us to speak the same language. We speak different language within the city limits of Washington, D.C. than people do outside. And it has to do with the concept known as current services. When ordinary people talk about increasing revenues, they mean more revenue next year than this year, or more revenue next month than this month. And when they talk about cutting expenses, they mean spending less next year than this year, or spending less next month than this month. But, that's not at all what's meant in the city limits of Washington, D.C.

When people here talk about cutting, they talk about cutting from inflated number called current services. And people outside the Beltway think something quite different.

There's newspeak that goes on within the city of Washington, D.C., and that, it seems to me, is a fundamental source of the extraordinary, excruciating misunderstanding about the budget that surrounds public discussion about it. And I'll come back to that in just a moment.

I want to talk a bit about the parameters of President Reagan's budget because that forms the foundation for the budget amendments that President Bush will talk about on Thursday, and it forms the basis for what your staff, no doubt, is looking at right now.

Remember that the budget deficit is estimated to be $161 billion for fiscal year 1989. The budget that President Reagan sent to Congress incorporates an increase in revenue of $84 billion. Now, I know that my colleagues think that some of those assumptions were quite generous. But CBO estimated the number at approximately the same level.

Now, on the outlay side, Reagan's budget envisioned a $15 billion increase in spending. Of that $15 billion, $4.7 billion goes to defense, $4.7 billion to entitlement programs, $4.1 billion to domestic appropriations, and $1.1 billion to foreign aid.

Now, I want to talk just a minute about the relative efficacy of the two major policy tools that are talked most about in this city, about dealing with the deficit, and those are spending restraint and increasing tax rates.

I know there's some literature, written by very good economists, that suggest Congress tends to spend more than an extra dollar for every extra dollar raised in revenue. Now, I won't address that literature right now, but what I will do is talk about two things.

One, an anecdote. I was Director of OMB for basically three budget cycles, 1987, 1988 and 1989. In fiscal year 1987, Ronald Reagan had a policy of no, no, no, a thousand times no. He threatened to veto any appropriations bill with excessive spending and to veto a reconciliation act that had too many bad things in it with not enough reform in entitlement programs. And what happened? The deficit came down from $221 billion to $150 billion.

Now, part of that reduction reflected an undulation in tax reform. We know that. I admit that. But the major reason it came down is because spending in real terms went down significantly for the first time in 20 years. And then we had the market crash of October of 1987, and what happened? The President was goaded into the so-called budget summit. And what came out of that budget summit was a substantial increase in outlays, and a substantial increase in revenues.

And what happened to the deficit? The deficit didn't go down; it went up. It went up from $150 billion to $155 billion, and up to $161 billion estimated for fiscal year 1989. That's the anecdote.

The data—and I want to stress right now that I've just started running some regressions, so it is very preliminary, and I don't want to suggest that I have anything ready to let loose on the world. But from what I've found so far, if you simply try to explain changes in the deficit over the last 25 years of data, changes in real terms, by changes in spending in real terms, and changes in marginal tax rates, you know what happens? You get a very predictable, sizable effect because of changes in spending on deficits, but you can't find any effect of changes in marginal tax rates.

Now, whether this means that a tax increase didn't raise revenue, or whether it raised revenue and Congress spent the money, I don't know.

I want now to just make a side bar comment about so-called rosy scenarios. I was Director of OMB for three budget cycles, and every time I came up before this committee I got banged on the head for rosy scenarios. Rosy scenario affects primarily the revenue side of the budget because the assumption about economic growth has its greatest effect there.

Recently I went back and wrote the numbers down. Anybody can do it. Wrote the numbers down from those three budgets as to what we projected revenues would be for the coming fiscal year, and what they actually were. And I wrote down what we projected outlays to be under the budget, the President's budget, and what they actually were. And you know what it showed? In 2 of the 3 years, and overall as well, it turned out that we underestimated receipts, didn't overestimate.

On the other hand, outlays were much higher than we had estimated. Now, that should suggest something to you about the causes of the deficit and about who was right and who wrong in terms of economic assumptions.

Now, the last point I want to make is that the American people apparently have very definite ideas about what the causes of the deficit are and what the solutions might be. Citizens for Sound Economy Foundation, a few weeks ago, made public a Roper poll on this question. And let me just give you a couple of data.

By a margin of 3 to 1, people blamed Congress more than the President for that deficit. By a margin of 6 to 1, they believe the primary cause of the deficit is increased spending, not inadequate tax revenues. And by an astonishing margin of 15 to 1, they prefer to deal with the deficit by holding down spending rather than raising taxes.

Now, these data are just overwhelming. It is not even close. These data tell a story that's quite persuasive, it seems to me, about where citizens want to go.

Now, I know what it's like to be on the minority side of an issue. My personal view has been to be in favor of the pay increase. And I know many of you are disappointed, but there was overwhelming evidence from the public at large on this issue: they didn't like it.

And I'm telling you that it seems to me, from these polling results, that there is overwhelming public outrage at the notion of a tax increase. And we can get into specifics in a minute with my colleagues. But I believe that it is possible to reduce the deficit substantially, to rely on economic growth. But it requires the will power to put restraints on spending and to make choices among priorities. There are some things in the budget that are more important than others. And I won't even speak to that, but just to make the point that you already know that some things are more important than others. And if you choose the more important things, and you let go the less important things, then you can reduce the deficit without raising taxes.

Thank you.

[The statement of Mr. Miller follows:]

PREPARED STATEMENT
of
JAMES C. MILLER III
before the
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
February 7, 1989

Mr. Chairman and Members of the Committee: I appreciate this opportunity to appear before this powerful committee and in such distinguished company.

As you know, from October, 1985, to October, 1989, I served as Director of the Office of Management and Budget. Since that time I have held concurrent positions as John M. Olin Distinguished Fellow at Citizens for a Sound Economy Foundation and the Center for Study of Public Choice at George Mason University. In addition, I have just been elected Chairman of the Board of Directors of Citizens for a Sound Economy, a 250,000-member citizen organization committed to fiscal discipline.

The Economy

The national economy has just ended six years of expansion, a peacetime record. Barring some catastrophe, this expansion should continue. The leading indicators are fairly firm (though they fluctuate from month to month). Moreover, our economic growth appears fairly balanced, with few bottlenecks, though a great measure of the increase is export-led. A majority of Blue-Chip forecasters say they don't expect a recession before 1990.

Despite recent increases, I anticipate that interest rates will moderate over time, especially short-term interest rates. Economic growth last year was quite high by historical standards, and this increase in aggregate supply served to restrain inflationary pressures. As we make further progress on the deficit, and as uncertainties over the Bush Administration's economic policies begin to subside, I would anticipate a further slight reduction in real interest rates, and this should draw down nominal interest rates. (The Federal Reserve, in my judgment, will not affect very much expectations about the rate of inflation this year.)

Total employment should continue to grow and thus set records nearly every month. Unemployment rates will remain low, though perhaps not as low as in recent months -- a 14 year low. There will continue to be an increase in labor force participation rates. This combination -- low unemployment rates and continued employment gains as well as increases in labor force participation -- is truly remarkable, all things considered.

Although the trade deficit tends to increase or decrease depending on the month, the longer-run trend is evident: it is on the way down. Moving averages show this. I would anticipate a further decline in the trade deficit brought on in part because of a lag in adjustment. (That is, an appreciation of foreign currencies relative to the dollar makes U.S. imports more expensive, but since demand for imports is fairly price inelastic in the short run, total imports in dollar terms go up faster than before; in the longer-term, this is reversed.) Also, I would anticipate a small further decline in the dollar, which will further accelerate a reduction in the trade deficit. This downward trend in the trade deficit is quite important in that it will take pressure off further protectionist trade legislation.

For the reasons sketched out above, I believe there is reason for optimism over the economy for the calendar year, and certainly the fiscal year. Of course, always there are threats looming on the horizon. I believe any of the following could lower substantially the economy's performance over the year ahead. First, a decision by the Federal Reserve to be "too tight" with the monetary aggregates. Second, a perception that the Federal government will fail to make further progress on the deficit. Third, a sizeable increase in the legislated minimum wage. Fourth, widespread imposition of so-called mandated benefits, financed off-budget. Fifth, appreciably more protectionist trade legislation. And finally, just plain bad luck. Although I want to emphasize that I expect none of these to come to pass, there is that risk. And while we can't do anything about bad luck, we can, and should, control these other threats to our economy.

The Deficit

Since these hearings, I gather, are a predicate to this committee's discussion of the budget deficit, I thought I would make several comments on this major issue before turning to your questions.

The first thing to bear in mind about the deficit is that we have made substantial progress already. In FY 1986 (which began just as I arrived at OMB), the deficit was $221 billion. The next year, FY 1987, the deficit fell to $150 billion -- the largest reduction in the deficit in the history of our country. But after the budget summit of November, 1987, progress on the deficit ceased: the deficit was $155 billion in FY 1988 and is projected by the Office of Management and Budget (OMB) to be $161 billion in FY 1989. Even so, the deficit as a proportion of gross national product (GNP) continues to fall. It was 5.3 percent of GNP in FY 1986; was 3.4 percent in FY 1987; was 3.2 percent in FY 1988; is predicted to be 3.2 percent again in FY 1989, and is projected to be 1.7 percent, under President Reagan's budget, in FY 1990.

On the other hand, I'm not one of those who believes that "the deficit doesn't matter." It does. Overall, it slows our rate of economic growth. Moreover, there is a moral or ethical dimension to the deficit that has received relatively little attention. Fiscal illusion does exist. People don't fully discount the cost of debt, and in this sense deficits do burden future generations -- some of whom aren't even born yet and have no say-so in today's decisionmaking.

The second point I'd like to make about the deficit is that a great amount of confusion and frustration could be alleviated if we'd all speak the same language. Those inside the Washington Beltway have developed a budget language indigenous to this area, built around the current services concept. So, when we speak about "cuts in spending" or "increases in revenues" we are not talking about the same thing as people outside the Beltway. When your average Joe or Jane talk about cutting spending or increasing revenue, they mean spending less next month (or next year) than this month (or this year). When they talk about increasing revenue, they mean making more money next month (or next year) than this month (or this year). As you know, in Washington, what may be characterized as a "massive cut" can really be an increase as viewed outside the Beltway; or what we in Washington might term a no-tax-increase policy might be viewed as a massive revenue increase beyond the Beltway. Therefore, I heartily recommend that we talk about the budget in nominal terms, not in terms of current services.

And this brings me to my third point, and that is to describe briefly the parameters of the budget President Reagan submitted on January 9th -- the budget that will form the basis for President Bush's amendments to be announced on Thursday, and the budget your staff no doubt is already poring over in great detail.

As you know, the Reagan budget predicts a deficit of $161 billion for FY 1989. For FY 1990, the Reagan budget projects a revenue increase, basically under current tax law, of $84 billion -- which, by itself, would bring the deficit for FY 1990 down to $77 billion. But the Reagan budget increases spending by $15 billion -- bringing the deficit estimate up to $92 billion. Of this $15 billion increase, some $4.7 billion would go to defense; $4.7 billion to entitlement programs; $4.1 billion to domestic appropriated accounts, and $1.1 billion to foreign aid.

The third point I'd like to make about the budget is the relative efficacy of the two major policy instruments for reducing the deficit that are discussed most often: spending restraint and tax rate increases. As you know, several academic papers claim to show that Congress spends more than an extra dollar for every extra dollar that is raised in revenue. I will not address that literature here, but will go to the point from a slightly different perspective.

Let me begin with an anecdote. In FY 1987, President Reagan held firm on spending -- threatening to veto any appropriations bill with excessive outlays -- and as a result total spending for FY 1987, in real terms, fell significantly for the first time in 20 years; and, incidentally, partly as a result of tax reform, as I said, the budget deficit fell from $221 billion to $150 billion. Then the market collapsed and President Reagan was goaded into the so-called budget summit; what we got out of those negotiations was a much more rapid increase in nominal spending and a tax increase -- and the deficit rose, not fell.

Now, let me tell you about some very preliminary results from a statistical analysis of the effects on the deficit of restraints on spending and increases in tax rates. Taking the last 25 years of data, I've tried to explain changes in the deficit by changes in total spending and changes in tax rates on individuals. While the results, again, are very preliminary, it appears that spending restraints have a significant effect on the deficit, whereas changes in tax rates do not. Whether this is a reflection of tax increases' having no discernible effect on total revenue or whether it is a reflection of Congress's proclivity to spend new revenue awaits further analysis. But these preliminary results should give pause to anyone who expects a tax increase to reduce the deficit.

The final point I'd like to make is that it would appear the American people have very definite ideas about the causes of the deficit and what should be done about it.

Recently CSE Foundation released a Roper poll about citizens' attitudes toward taxes, spending, and the deficit. By a ratio of 3 to 1, American citizens say Congress is more to blame for the deficit than the President. By a ratio of 6 to 1, people believe the primary cause of the deficit is too much spending rather than not enough taxes. And by an astonishing 15 to 1, citizens agree with what Foundation President Wayne Gable said in introducing the poll: "The American people want to reduce the deficit through spending restraint, not tax increases."

By 3 to 1, citizens support a freeze on spending. However, they are evenly split on whether the spending level should be adjusted for inflation. And by large margins they would want to exempt some programs, such as Social Security, meaning that spending on lower priorities would have to go down in order to keep total spending within the overall cap.

Through all of this data comes a citizen message loud and clear. Vice President Dan Quayle, speaking at a conference sponsored by the Foundation, summed it up this way: "Most Americans understand that holding spending down, rather than raising taxes, is the route to deficit reduction."

Conclusion

Mr. Chairman and Members of the Committee: this concludes my prepared statement; I shall be happy now to address any questions you might have.

Mr. GIBBONS. Thank you, sir.

The chairman said he would like to go to sort of a roundtable discussion and Mr. Miller, when he started this, said that he would like to enter into a dialog with his fellow panelists up there.

I wonder if we could start that way, and then members come in as we go along. And we will just kind of have a free-for-all, no holds barred, and see how it works out.

Mr. MILLER. Well, I guess I would take exception to the statement that economic growth has been rather paltry during the 1980's. And I refer to page 339 in the most recent Council of Economic Advisers report.

I know that Larry Summers is quite familiar with this document, having had at least gone through one cycle of putting an economic report together.

But if you look at the data, output in constant dollars has been quite high, and it's continued to rise all through the decade of the 1980's. And you could look at the same data for disposable income per capita. It has been rising through this whole period.

The savings rate is low, but I would suggest, as Larry mentioned at the very end of his remarks, even if you eliminated the deficit, we would still have a large savings gap vis-a-vis other countries. But a major reason is the demographics. We have, as you know, the "baby boom" going through and they're at the time of their lives when they're typically dissaving rather than saving. The savings problem: some of it will be solved as time goes on.

Mr. SUMMERS. That's just not right. I mean a lot of people have now looked at the question of how much of the movements in the saving rate can be explained by the change in demography. And with the sole exception of Ed Giardini, who bases his conclusion on VCR sales, everyone who has looked at that issue has concluded that it is three-tenths of a percentage point issue.

I think it would be a big mistake to suppose that the demography is going to push the saving rate up any time in the next——

Mr. MILLER. Well, it will push it some, but we have cultural differences with Japan and incentives for us to consume rather than to save. And that's one reason, I think, we ought to examine our Tax Code—the differential effects of incentives on saving versus consumption.

Wouldn't you agree with that?

Mr. TOBIN. Well, even if we went back to the saving habits before 1980 in this country, we would still be a low saving country relative to Japan and even to Western Europe.

But we are not even doing as well as we ourselves used to do before 1980. So that makes it all the worse, particularly in the competitive world economy that we now have where we really need increases in productivity or else we are going to have to pay back or service our international debt at much worse terms of foreign exchange than we had when we incurred the debt. It's going to be very expensive to our future generations to do that.

So I think we do need a much higher saving rate, and we haven't had it. And the easiest way, the first way, to get it is for the Government to stop doing negative saving. Maybe we can improve the incentives and the propensity to save of American households and businesses. But that's much more difficult to do. We can't order them to save more. But certainly the Federal Government can do better on its own, and that would be the biggest contribution to the improvement of national saving.

Mr. GIBBONS. Wouldn't pulling the Social Security trust fund out of the budget, and it would be pulled out other than Gramm-Rudman. We passed Gramm-Rudman, we put it back in. We took it out once and put it back in, not understanding what we were doing.

Wouldn't pulling that out, and then balancing the budget really increase the savings rate in this country?

Mr. TOBIN. Oh, yes, that would be just great.

Mr. GIBBONS. That would be the best thing we could do.

Mr. TOBIN. That would be the best thing that you could do, that we could do as a matter of policy.

Now, what you have to do is to change the focus of political, legislative, and media attention to what the deficit really is.

Mr. GIBBONS. Well, what we've got now is lulling us to sleep because the Social Security system, piling up its reserves, is making us believe that the budget deficit is coming down, when it really is not coming down.

Mr. SUMMERS. It would be worth about 2 percentage points on the saving rate to make the change you suggest.

Mr. GIBBONS. Mr. Miller, why don't we do that?

Mr. MILLER. I think we should do that. I really do. I'm out of Government now. I can tell you what I think. [Laughter.]

Mr. GIBBONS. I like that.

Mr. BROWN. Mr. Chairman.

Mr. MILLER. Could I just wrap up a point? This is a controversial point I know, but I think it's essential that we tell the trustees of the Social Security system not to invest in Government bonds. And that would solve the problem, because that would wipe out the surplus——

Mr. GIBBONS. Where are they going to invest?

Mr. MILLER. Do you realize how large a surplus we are talking about? A $12 trillion surplus. What they should do is to buy commercial debt. What they should do is to buy real assets. What they might do is follow Jeff Eisenach's recent suggestion in the Wall Street Journal—buy bonds of State and local governments. There are a lot of ways to utilize that savings so that when we get out to the year 2010, 2020, or 2030, whenever you start paying down the Social Security trust fund, you find that what is in the surplus box is something more than an IOU on those working people that Professor Tobin talked about.

I mean, if you have a situation where you have a very large group of people at the top of, basically, a Ponzi scheme that is being paid by a relatively narrowing base, you have laid the seeds of intergenerational strife of substantial proportions, and I think that is something we ought to avoid.

Mr. GIBBONS. Let's go over here and then come back to Gephardt. You know, just kick it around. You don't have to get each other to yield.

Mr. BROWN. Mr. Chairman, I wanted to ask of the panel a question. Many experts have suggested that the major reasons that people save involve basically three items: First, they save for their retirement, second, they save for health emergency, concern about their health, and third, they save to educate their children.

There are other reasons, of course, wealth accumulation and so on, but the three the basic ones that seem to be the big motivators all are ones in which Government programs have stepped in and said: If you don't have money to send your kids to school, we will pay for it. If you don't have money for emergency health care, we will provide it. If you don't have money for minimum standards of retirement, we will take care of it.

Many experts are saying that the Government policies themselves, motivated by fine, humane inclinations I am sure, are responsible for our low savings rate. I would be interested in the comments of any of the members of the panel on that subject, and I would wonder if any of them want to change the Federal programs.

Mr. SUMMERS. Perhaps I could speak to that. In Japan, when you apply to college, there is financial aid as there is here. The financial aid is based entirely on your parents' income. It is not based at all on your parents' wealth, and so the kind of tax that Harvard, for example, applies, which is you have got one kid, you have $12,000 in the bank, that is $3,000 a year off the financial aid award, that kind of tax isn't present in Japan.

I think there is some argument for altering some of those, moving in that direction in some of our programs in the United States. At the same time, I think the fact that people can afford to go to college, people are secure about their old age, and that people are secure that they will be able to get health care if something happens to them are very valuable and very important accomplishments. And rather than saying our route to increasing saving is let's make people insecure so they will save seems to me to be the drift of a policy that responds directly from that, better is to recognize that because we have taken away some of those private motives for saving there is going to be more of a need for the Government to take a close pro-saving posture in its other activities, more of a need for the Government to avoid borrowing, more of a need for the Government to preserve the integrity of the Social Security system, and more of a need for the Government to try to provide incentives for private saving.

So I would prefer to recognize that I think that diagnosis has considerable validity in understanding why we have a low rate of saving, but at the same time I don't think that you fill the tire, you put the air in where the tire leaks. So I would rather see us move in different ways to increase saving than by increasing insecurity.

Mr. GIBBONS. Let's just kick it around a while.

Mr. GEPHARDT. If it strikes your fancy, we can get you in it.

I wanted to go back to both productivity and savings rate. I know they are, obviously, not the same, but can any of you give your thoughts about why you think our productivity fell off? I have read the papers by the gentleman at Commerce, his name is escaping me right now. Denning, I think, or something.

Mr. TOBIN. Denison.

Mr. SUMMERS. Denison.

Mr. GEPHARDT. Denison—who has done the studies, and I have talked to him and he apparently is one of our great experts. He doesn't quite understand it. So I kind of gave up after I talked to him of anybody knowing what is going on. He talked about the end of people coming off the farms and things like that.

Do any of you have any great thoughts about this and what the root causes are? I mean, if you really look at where we are vis-a-vis the rest of the world, if we can't deal with that and get it moving in a better direction, it really seems to me our standard of living has to decline. What are your thoughts?

Mr. TOBIN. Well, I don't think we know more than Ed Denison does. It is a mysterious thing that happened not just in the United States but elsewhere too, that in the mid-1970's the rate of productivity growth declined and has stayed down. Maybe it was something to do with the oil and energy shortage of the times, but Denison didn't find evidence than the coincidence of time for that.

Mr. GEPHARDT. Was the decrease in Japan and Western Europe as much as it has been here?

Mr. TOBIN. I think the decrease was as much, but they were higher to begin with.

Mr. GEPHARDT. Higher to begin with, so they are still higher than we are. But they did sustain a loss in that post-1973 period?

Mr. TOBIN. They seem to have recovered better than we did in the rate of productivity growth.

Mr. SUMMERS. I can quote you some numbers that will give the right—I don't have exactly the correct numbers in my head, but these numbers will give you the right impression.

If prior to 1973 Japan had productivity growth at 7 percent and we had productivity at 2½ percent, after 1973 we have had productivity growth at 1 percent and they have had productivity growth at 4 percent. So they have slowed down, 7 to 4 versus 2½ to 1, by more than we have actually slowed down, but that is, in a sense making it too complicated. What remains true is that they are catching up and pulling away at 4 versus 1, 3 percent a year, and that is a serious problem for us.

I think this is one of those things where even if we can't explain all the things that have happened that have been associated with the productivity slowdown we do know some things about things that affects productivity. We do know that countries where capital increases rapidly are countries that have more rapid productivity growth. We know just from the evidence of the market that skills are very important. In 1979, a 26-year-old who had gone to college earned 25 percent more than a 26-year-old who hadn't. Last year that number was 57 percent. Well, that is telling you something about what is happening in terms of demand for skilled workers in our economy and the supply of skilled workers.

So I think we know things about physical capital, human capital investments that work to increase productivity even if we don't know anything.

Let me say one other thing. Nobody has been able to tell a completely convincing causal story that links it all up, and if you look at the many economic sort of time series and you see which ones seem to precede productivity very well, what you are struck by is the correlation with public investment in infrastructure which begins a very sharp fall-off around 1970 right before the productivity slowdown. I don't want to say that fewer bridges is the reason we have the productivity slowdown, but one does have to be struck that there is a strong correlation there.

Mr. **Miller**. Could I just add that I think most of what my colleagues said is absolutely on the mark. In terms of aggregate figures, I mean the kinds of explanations sometimes you hear are a gradual shifting to service industries where it is just inherently more difficult to increase productivity, and also at the same time we have had some stifling of our capital accumulation. Also, we have had great increases in total employment and in labor force participation rates.

But let me just make a point, and it is not trying to defend what we have and certainly Japan is something of an outlier here. But it is certainly possible for other countries that are behind us in terms of gross national product to have rates of increase in productivity that are higher than ours, yet never catch us.

For example, each year my son's proportionate increase in age is greater than my proportionate increase in age but he will never be as old as I am.

Mr. **Tobin**. We are waiting for that to happen.

Mr. **Levin**. But before you agree too much, I just wanted to chime in, to talk just for a minute or 2 about your disagreements because we have a rare opportunity to have kind of an informal discussion.

Your disagreements are striking. I think if somebody were listening from far away they would wonder if you are talking about the same countries, and this is a continuing pattern here. What is the cause of your disagreements? If you had to guess, why do the two of you—not that you agree on everything—have such a different view of this world than Jim Miller, and why do you have such a very different view than the two of them?

It is so different. When you approach the deficit, however you slice it, you have a very different reaction to it in terms of urgency, and in terms of the growth rate, and percentages, the arguments you marshall. What drives it?

Dr. Tobin, you have been at this longer than the others? What is underlying this?

Mr. **Tobin**. I have the impression that the main objective of the Reagan revolution was to reduce the size of civilian government, to get Government activities other than defense reduced in scope and size relative to the size of the society and the economy, and that was number 1 priority. Get Government off the backs of the American people. Get it down in terms of taxes, spending, regulations, and everything. And that was an objective that was bigger than deficits, bigger than growth, economic growth, and everything. And I think to some extent the strategy was to run deficits and then use the existence of the deficits as a way to get civilian spending reduced.

I think I have a much less extreme view of Government spending. Some of it is bad, some of it is good, some of it is essential for economic growth, and a lot of it is important. And the way it looks to me in the last 8 years the Federal Government has been on artificial starvation rations. Things that ought to be done in this economy, in this society, whether it be to protect the environment or to make American children better educated or more healthy, those things are just not being done. Not because the society isn't rich enough to do them, but because this artificial restriction on the raising of revenues has been imposed politically.

You know, Jim Miller says, well, that is what the American people want. Well, as I see it, the American people want inconsistent things. They don't want to get rid of all the civilian spending programs. If you mention the things that I just mentioned and many others, they will say they are for them. And, if you say, "Are you against spending in general?", they will say they are against spending in general and they are not in favor of taxes being increased. If you say, "Are you willing to pay higher taxes to do more for education or more for child support or public health?", they will say, "Yes, for that we are willing to do it."

It seems to me the challenge of political leadership is to show the public consistent accounting and consistent reckoning of what has to be done to meet national objectives, and not to play games with them in this arithmetically inconsistent way, which is what we have been doing for 8 years.

Mr. MILLER. To a large extent, I think Professor Tobin is correct in his characterization. I think my own personal preference is to focus on three things. To what extent do we disagree over the simple economic analysis, and actually I think we agree much more than it might seem from just listening from afar. The second is to what extent do we disagree over what I think Professor Summers rightly said is not necessarily the domain of an economist, and that is over what you should do with having analysis in hand—what choices you make, what priorities you set. Maybe we have some disagreements there. That is only natural.

On the other hand, I would make a third point, and that is this I come from the so-called public choice school. That is, I believe that our decisionmaking processes lead to excessive spending in the Government sector, and we do not spend money at the margin very efficiently. And the question would be, can you reduce the spending on those items that are of low priority? I am more optimistic, I guess. I think that you can if Congress will make those tough choices and the size of the Government will be more consistent with what would be the optimal size of Government.

But let me say finally, we have hardly been niggardly with respect to receipts and outlays. Here are the historical tables, relating spending in real dollars, constant 1982 dollars. In 1980 total spending was $699 billion, and the projection for 1990 is $881.2 billion; and receipts were $611.7 billion in 1980 and the estimate for 1990 is $810.4 billion. So outlays and receipts have both gone up in real terms under the Reagan presidency.

Mr. SUMMERS. I think you have gotten a partial answer to your question but not a fully satisfactory one. Part of it is values. Jim Tobin thinks and I think that a slightly enlarged revenue base would permit the Government to meet some urgent national needs. Jim Miller thinks that a slightly enlarged revenue base would permit the Government to squander some more money. That means we think about it differently.

Mr. MILLER. That is a pretty good summary.

Mr. SUMMERS. That doesn't really explain why people like Jim and I think that the administration forecast is ludicrous and that continued large deficits will greatly hurt American competitiveness, and people like Jim Miller think that the administration forecast is a passable forecast and the deficit is already on a downward trend and no big deal. That is a basic economic question and we haven't given you a good explanation of why we differ. I think part of the reason is that Jim and I are right and Jim Miller is wrong. [Laughter.]

Mr. LEVIN. So that is the rest of the answer, right?

Mr. SUMMERS. I fear that that is much of the rest of the answer.

Mr. MILLER. Could I correct an impression I may have given? And that is, that I don't think deficits matter. I do think they do matter. I think they matter a lot.

Mr. LEVIN. But not much.

Mr. MILLER. No. I—well, I——

Mr. LEVIN. I mean, the feeling you give is they matter but not much.

Mr. MILLER. Well, I am sorry I give that impression. I believe deficits matter a lot and I spent an enormous amount of my time while I was in the Federal Government battling to get deficits down. We made a great deal of progress but we still have a long way to go. And I would remove the Social Security surplus from the deficit calculation, as both of these gentlemen would.

Mr. SUMMERS. Let me give you——

Mr. LEVIN. Wait a minute. We are not yielding; this is very informal.

Mr. FLIPPO. Well, I just wanted to along those lines say that I read recently where Mr. Boskins and I believe it is—is it Mr. Rahn?

Mr. MILLER. Rahn. Richard Rahn.

Mr. FLIPPO [continuing]. Were both quoted as saying that "the present level of the deficit is not cause for alarm." What do you think they mean by that, that deficits don't matter or the level of the deficit is the important factor.

Mr. MILLER. Well, let me say I would agree with that statement. I will tell you what I mean. I mean that I don't see any impending disaster because the deficit would be $100 billion in 1990. But, on the other hand, I think we damn well ought to get the deficit down, eliminate it and take the Social Security surplus off of the deficit, which means getting it down a lot further.

Mr. FLIPPO. But nothing disastrous is likely to happen if we just kind of leave it alone. I mean, that seems to be what we are saying. I understand that it is not a short-term political imperative. That has been made quite obvious over the last 8 years. But it is a political, I mean the essence of the difficulty is how do you develop—the political challenge is how do you convert it from a long-term, absolute, unquestionable disaster to a short-term political imperative?

Mr. TOBIN. I think the problem is that a sudden marked sharp catastrophe is not the most likely thing to happen at any time. The danger is not a day of reckoning, one day like the 1932-33 collapse of the banking system—in an economy that already had a lot of unemployment and then had a lot more. That is not the sort of thing that we are facing, most likely.

We may have more days like October 19, 1987, but even that was not the 1932-33 kind of catastrophe. So what we are talking about is a more insidious erosion of the sources of productivity growth, and that is harder to make people excited about.

Mr. **Miller**. And I agree with that.

Mr. **Flippo**. I was just thinking that disaster might occur this year as we bump into Gramm-Rudman, is the message that I get from the statement of these two gentlemen that the present level of the deficit is not cause for alarm, is that support for delaying the implementation of Gramm-Rudman targets?

Would anything happen to us economically? Whether or not we adhered to the Gramm-Rudman targets, would that cause anything to happen to us?

Mr. **Miller**. Congressman, I have just said that I agree with that statement, but I would object to changing the Gramm-Rudman-Hollings targets.

Mr. **Summers**. At a minimum, keeping on going is like smoking four packs a day. Not real smart and there is a good chance that it will get you in the end. There is some risk that—it is like going to try and play in traffic, and I think a lot of what creates the controversy is that in an effort to dramatize the problem in order to get action there has been some tendency to say the world will end in the next 9 months if you don't do something about the deficit, and then other people rather properly say that is exaggerating a bit, and then an argument ensues, and it is because it is difficult to generate action on the strength of the argument which a very wide part of the political spectrum would agree on, that it is like smoking four packs a day, which is to say very serious but not an imminent and immediate problem.

Mr. **Flippo**. Well, it just seems to me that if we continue to give folks what they want, I suppose, if we continue down the present path, which is giving people what they want that we will one day come to that point where we will reach that crisis point. But I just think that it is imperative in my mind that Government say there is a day of reckoning and begin to direct the political leadership to build a consensus to stop that deficit spending approach.

Thank you, Mr. Chairman.

Mr. **Gephardt** [presiding]. Thank you, Congressman.

I believe Nancy Johnson has a question.

Mrs. **Johnson**. I want to make a couple of comments. As one who has served on the Budget Committee and has watched this matter of economic assumptions very closely, and is deeply concerned about the issue that Jim Miller raised, I don't believe for a moment that you are giving this anywhere near the amount of attention that is needed. That is the language problems that we have within the Beltway here.

I am curious why, Dr. Summers and Dr. Tobin, you didn't respond to Miller's comment that in spite of all the differences we have about the assumptions that 2 out of 3 years his revenue estimates were low, as well as the outlay projections being very low.

In other words, we have had some revenue elasticity in these last few years and we have still been unable to budget in any way near reality. Regardless of whether you think Reagan's goal was to reduce the role of Government or whether you think it wasn't, at least he was straight about it. He brought up here budgets that said, I am going to increase defense and I am going to cut domestic programs.

Why is it that we are never held accountable in this body, unlike what happened on the floor today? People were fed up with Congress not being held accountable. Whether they were for the pay raise or not, they didn't like not voting on it. And in your statements you do not at all hold us accountable for the fact that we accepted the increases in defense and we refused to look at the reality of the outlays.

I did find, Larry, your analysis of possible tax options very useful and very helpful, because I happen to be one of those that in the long run think there is no way that we can do this without revenues. But isn't it curious that we have had better input on how to deal with the tax side than we have had on how to deal with the spending side, which is clearly something that we have failed to do with.

And our failure has been, in my estimation, more abysmal than the past President's. Because at least he came up here with the unpopular things. I disagreed with him on a lot of those, but we could not build a majority for any substitute. Now we are into a very difficult situation and yet you are strongly criticizing assumptions. Your comments in response to Jim's comments on his assumptions in a sense were not adequate. When you look at all of the estimators out there, Jim's office has been just about as accurate as any other office over time. So we are never going to solve the assumptions issue absolutely.

We have been more realistic and we now have more information out on the tax issue than we have ever had. But we are struggling terribly on the spending side. We don't even understand the policy implications. For example, health care is still the one industry that any invention is to be profitable because any invention is going to be bought by the next hospital and every hospital for liability purposes. We are not talking about that as a driver of health care costs.

So I am real frustrated that we spend our time talking about assumptions which are important, and tax options. Apparently, you economists feel little obligation to talk about the policy issues that are driving the spending side.

I am sorry that I haven't come down to the spending questions. Aside from the basis you used to make the projections, isn't it of significance to you that 2 out of 3 years the revenues were actually higher than projected by Miller's office?

Mr. SUMMERS. I will study the statistics and will go back and study the projection and will write you a letter describing how I would interpret that in light of the claims that the forecasts were consistently too optimistic.

I would just say this year, I would ask whether there is anybody in this room who thinks that the Treasury bill rate is going to be 3 percent in 1994, and who thinks that that is a useful anything in a planning exercise, especially a planning exercise that assumes a very rapid economic growth.

You know, you can cite statistics on both sides of these arguments. The reason I didn't place a lot of blame on Congress' overspending was that I knew that of the $1.5 trillion of debt that had been accumulated over the last 8 years, if the President had gotten all of his spending requests in all of the years, more than 90 percent of that debt would have been accumulated.

The fact is that the Congress cut the President's defense requests by just about the same amount that they increased his domestic requests.

Mr. MILLER. But they didn't make the modifications in entitlement programs that would have saved additional——

Mr. SUMMERS. Although in many years the President did not propose the modifications.

Mr. MOODY. So the President backed off of those.

Mr. MILLER. He did proper modifications all the years I was in OMB.

Mr. SUMMERS. He didn't touch Social Security while you were there.

Mr. MILLER. No, no, no, but modifications in other entitlements.

Mrs. JOHNSON. I would question your former assumption that, in fact, we made commensurate domestic spending cuts. We often started programs with very, very small amounts of money, knowing that the next year was going to be 10 or 20 times the cost. That goes back to this "speak" problem that Jim was talking about.

One of the reasons why it has been just an ideological conversation about the role of Government rather than looking at what is actually going on, is because of the current spending problem and the short funding of costs in the current years.

So I think we have got to grapple more with the policies that are driving spending if we are ever going to get the deficit down, which I consider to be a very important responsibility.

Mr. TOBIN. If you wanted to increase, in a very short period of time, the rate of defense spending so that instead of 5 percent of GNP defense spending is to be 6½, 7, and in original projections of the Reagan administration 8 percent of GNP—if you want to do that, then that is a judgment that the Nation can afford it, with which I don't quarrel.

I think we could afford to do that. If it is necessary to do it on foreign policy and national security purposes, we can afford as much a percentage of GNP as we did in the 1950's and early 1960's, which was 10 percent.

But the question is how is a nation which can afford it going to pay for it. What uses of resources are going to give up the resources that are needed for an expansion of defense?

It is certainly not obvious that it should be the resources that are devoted to entitlements other than Social Security or social services. It is certainly not obvious that it is any Federal program rather than personal consumption which should give up the needed resources.

One might think if you have an additional burden to defend yourself, then everyone ought to contribute to it. It ought to be contributed to by old people, young people, rich people, poor people, and not by people who just happen to be beneficiaries of Federal civilian programs.

And if you did that, you would ask the country to pay for the higher defense program by paying higher taxes instead of reducing taxes at the very same time that you are asking for the country to put more of its resources into defense.

So I think the President was asking the Congress to do an impossible thing. Actually, what Congress did do was to reduce the amount of discretionary civilian spending from more than 5 percent of GNP to less than 4 percent, 3.7 percent of GNP, over that period of time.

It is not surprising to me, given that taxes had been reduced and the political imperative was not to push them back up again, that the Congress eventually forced the President to give up on his aspirations for so large an increase in defense.

We have had several occasions in postwar history when, for one reason or another, it was considered desirable, even necessary for national security, to increase the share of national product that was going for national security.

One was the Korean war. Immediately after the Second World War, it was thought now we could reduce defense spending, and we did. Then comes the Korean war. Truman asked for enough taxes to pay for the Korean war, and he actually improved the budget during the same period we were fighting the Korean war. The deficit went down and the taxes created a surplus. We didn't have an inflation problem; economically, everything went fine.

Johnson made the mistake of trying to fight the Vietnam war without paying for it at the time. Reagan made the mistake of having his buildup without paying for it by taxes. Both of those times, we got into trouble.

Mrs. JOHNSON. I guess the only difference between us is that I would remind you that only Congress appropriates and only Congress taxes and only Congress can hold the final responsibility for not funding that war or for allowing the deficit to be built up.

Mr. MOODY. Would you yield for one second?

Mrs. JOHNSON. I am done.

Mr. MOODY. The 200-year record of Congress and the Nation, however, is that Congress cannot pass a tax bill without Presidential leadership.

Mr. TOBIN. That is what I meant.

Mr. MOODY. So you can blame Congress, but you also must blame both branches of the Government because you cannot pass a tax bill with the Congress——

Mr. TOBIN. By itself.

Mr. MOODY. By itself. It just simply can't be done.

Mr. GEPHARDT. Don, do you have a question?

Mr. SUNDQUIST. Thank you, Mr. Chairman.

It seems that—Dr. Summers, you said there are two of you and one of Mr. Miller, but maybe this is an incorrect interpretation.

I don't think you want to leave the impression that those who are in favor of raising taxes are the only ones in favor of balancing the budget, and those who are in favor of cutting spending are not in favor of balancing the budget. That is not a fair assumption, is it?

Mr. SUMMERS. No. I think that everyone is in favor of a balanced budget. I think that those of us who think that the 1981 tax bill is excessive are likely to regard balancing the budget as a more important priority relative to other priorities than those of us who think the 1981 tax bill was great.

Mr. **Sundquist**. Going back to that tax bill, that is a difference in philosophy among economists that you could argue about all day. Is that a fair assumption?

Mr. **Summers**. Yes.

Mr. **Sundquist**. You know, we are not going to settle that argument today. But my specific question is this: In your testimony you talk about limiting the deductibility of corporate interest.

We have been hearing testimony this week on what we should do about LBO's. If, in fact, we limit the deductibility of corporate interest, number 1, does that not injure small business? And, number 2, would you use that money that you gain to make it revenue-neutral and do something about the double taxation of dividends?

Mr. **Summers**. I testified before your colleagues in the Senate at length on the LBO issue, and at that time what I proposed was limitations on corporate interest deductions that were taken in situations where there wasn't any interest actually paid through the issuance of zero coupon bonds and through the issuance of so-called PIK securities that were basically equity masquerading as debt where it was very junior.

In effect, what the debtor had was a residual claim on the company, and that is what we mean by equity. So that wouldn't touch small business at all. It would raise revenue.

I think that there is an argument for using the revenues that you generated to reduce the taxation of dividends if, and only if, it is only reduction in taxation of dividends on equity that is issued after this moment.

I don't think there is any reason to reduce the taxation on the pay-out of profits that have been earned on investments that were made in the past in anticipation of the dividend taxes that we have right now. So I think there is an argument for doing that.

If you ask me at a time when we have a still large budget deficit, at a time when we are not making a lot of progress in reducing that budget deficit, is the best single use I can think of $3 billion of Federal money that you might raise through controlling interest deductions—is the best single use of that money that I can think of to reduce dividend taxes even prospectively, I guess I would have to say probably not.

But over time when the budgetary pressure is less severe, if we are doing a whole set of measures, I think ultimately we will have to move toward something that will reduce the taxation of dividends, but I hope we do it in a way that only applies to dividends on new equity issues.

Mr. **Sundquist**. One final question, Mr. Chairman.

If you would be brief, I will ask Mr. Miller first. What will be the effect if, in fact, we can't come to some budget agreements this year, of sequestration on the financial markets, on the Congress, and the country?

Mr. **Miller**. Well, I think financial markets will be certainly discombobulated in a sense. They seem to place a very high premium on the notion that members of Congress and the President and the Vice President and other members of his team can come and sit and reason together and do something rational.

A sequester is a revealing that there was a failure of rational thinking, or there was no rational thinking. A sequester is just a god-awful way of trying to get the deficit down.

I mean, the whole idea behind the sequester was to make sure it never happened, to be so awful to make sure—it was supposed to be a strong incentive to make sure that Congress and the administration came together and did something to thwart the need for a sequester.

Mr. SUNDQUIST. Thank you. Thank you, Mr. Chairman.

Mr. MILLER. Let me tell you, Congressman, my last official act as Director of OMB was to give the President that October 15 report, and I sweated bullets over that because I made a promise to my dying father that I was going to be honest in that report and I was going to call it as I saw it. And that number came up awfully close to the ceiling, too.

Mr. SUNDQUIST. Thank you.

Mr. GEPHARDT. Mr. Moody.

Mr. MOODY. Thank you, Mr. Chairman.

I want to say what a pleasure it is to have you here. It was a real thrill for me as someone who read Dr. Tobin's work when I was a graduate student in economics at Berkeley. I enjoy having you here personally.

I read Dr. Miller's airline deregulation material as a grad student, so this is a real extra dividend of going to Congress.

And I want to congratulate Mr. Miller on his honesty as head of OMB. I think that Congress really appreciates the forthright manner that you have dealt with us, and we didn't get that feeling, I gather, sometimes in the past previous to you.

Let me ask you about the internal consistency of the administration's projections, Dr. Miller. In 1990, you have growth rates substantially above the blue chip and substantially above CBO; I guess 3.2.

And yet the internal consistency raises questions because you have got interest rates dropping on 30-day bills to 5.5. How would you have a heating-up of the economy, a fall in the unemployment rate, and a drop of this magnitude in interest rates?

What is the 30-day rate now, in the 8-percent range?

Mr. MILLER. It is about 8.3, something like that.

Mr. MOODY. Well, does anyone still think it is going to drop to 5.5 in 30-day rates?

Mr. MILLER. Well, let me say a couple of things. We are talking about 1990 now, which doesn't begin until next October.

Mr. MOODY. Right.

Mr. MILLER. A couple of things in that regard. One, we could have a disagreement over what the potential aggregate supply would be; in other words, at what rate of growth is it feasible without substantial inflationary pressures.

Mr. MOODY. Right.

Mr. MILLER. I probably would think it is a little higher than these gentlemen here, but 3.2 is a credible number, in my judgment, and I readily concede that most private forecasters think it is less.

Mr. Moody. I wasn't so much quarreling with that as I am the inconsistency of having unemployment go down, the GNP percentage go up, and then interest rates simultaneously plunge down.

Mr. Miller. Right. But, Jim, if you had had the capacity of the economy to grow like that——

Mr. Moody. Yes, if you had a lot of slack capacity.

Mr. Miller. If you had a lot of slack capacity, but even if you believe for a number of reasons, whether it is work force participation rates or whatever, that the economy could grow that much without inflationary pressures, that could happen.

I tend to think that the interest rate assumption is a little too low. I didn't fashion these assumptions; they were prepared immediately after the election. But I would point out that the sensitivity analysis on page 325 of the Reagan budget if the interest rate were 1 percent higher than presumed—the hit on the deficit would be about $4.5 billion.

Mr. Moody. For 1 point?

Mr. Miller. For 1 point. That is for 1990. Of course, there is a wedge and it grows out over the years.

Mr. Moody. Right, it goes out.

Mr. Miller. You are right to point this out. But I think you can be consistent, depending on what your view is of potential supply.

Mr. Moody. But we have had all this expansion, which is, of course, to be lauded, and tightening of capacity, and at the same time we are projecting a scenario which might be plausible, but only in a slack capacity scenario. We are not in a slack capacity, I don't think, are we?

Mr. Miller. Well, for the past 6 years we have had enormous growth in real output, a substantial fall in the unemployment rate, a substantial increase in total employment and labor force participation rates, and a substantial reduction in interest rates.

Mr. Moody. Real interest rates?

Mr. Miller. No.

Mr. Moody. Not as much.

Mr. Miller. Real interest rates have been wobbly.

Mr. Moody. Exactly.

Would the other gentlemen care to comment on my question about internal consistency?

Mr. Summers. I think you raised the right issue, and I think they are not basically internally consistent in a plausible way. I think it is a mistake to always focus just on the 1-year-ahead forecasts because I think people really wouldn't be worried about the deficit problem, whatever they thought the deficit was going to be this year, if they thought it was going to be on a clear downward path.

So that is why I targeted my criticism to the multiyear outlook that was contained in the administration's forecast, and however implausible that 3-percent growth and falling interest rates is for 1 year, as a continuing situation for 5 years it is a lot more implausible.

Mr. Moody. On the other hand, the further out you get, the harder it is to estimate. That is why I focused on the near term and only on the internal consistency within the near term. That is what caught my eye.

Professor Tobin, do you have any comments? Would you agree with your colleagues?

Mr. TOBIN. I believe the administration forecast is inconsistent. It is over-optimistic in regard to what can be done in terms of real economic growth without further reduction of the unemployment rate, and also increases in the risk of inflation.

Mr. MOODY. Right.

Mr. TOBIN. So I think the CBO forecast projection seems in line with the median of economics profession forecasts.

Mr. MILLER. More so.

Mr. MOODY. Thank you. I would like to return for a moment, if I could, Dr. Miller, to your point about the public choice theory. I certainly enjoy reading that material, and Bill Niskanen was a professor of mine at Berkeley and I feel comfortable with it.

But, you know, it may be true that there are systematic incentives to expand spending beyond the optimum and in some aggregate sense, but that isn't necessarily true politically with respect to specific programs.

Mr. MILLER. Yes, sure.

Mr. MOODY. I mean, we may be systematically underfunding education.

Mr. MILLER. Government Salaries.

Mr. MOODY. Salaries, yes. I voted for the pay raise today.

We may be systematically underfunding education, environment, a whole host of productivity issues——

Mr. MILLER. Right.

Mr. MOODY [continuing]. Which pay for themselves, because you have to think of them as investments rather than spending. And so I am not sure that public choice gives us any guidance when it comes to the micro-issues which really have to do with productivity and, therefore, our long-term competitiveness and the trade deficit and a lot of other things.

So in some aggregate sense, yes, the public is tired of taxes and they feel a lot of them are wasted. But I think public opinion—and I raise that you have used the quote of public opinion in your presentation.

Mr. MILLER. Right.

Mr. MOODY. Public opinion has swung pretty dramatically in the last few years on whether or not we are wasting money at the margin on a lot of other investment, education, et cetera, type programs.

Any comment on that?

Mr. MILLER. Your point is very well taken. I mean, public choice can, I think, help some even there, but I think its major contribution is in the aggregate.

Mr. TOBIN. I have always been puzzled a little bit about the philosophical aspects of public choice theory when it is combined with giving advice to Congress and to other policymakers. As I understand public choice theory, the theory says that you guys, Members of Congress, the President, and so on, are purely engaged in self-interested political behavior and you are going to do what you are going to do just the way businessmen are.

Mr. MOODY. We disproved that today.

Mr. Tobin. So the reason you have a hearing, I think, is to be advised on what you ought to do for the good of the country. And it seems rather strange to me for Jim Miller to come and say in effect: I am a public choice theorist, which says I know you are not going to do what is good for the country and I am advising you to do some things and not do others knowing as I do that you won't ever do things right.

Mr. Miller. Let me defend public choice just a moment, if I might. Public choice doesn't presume that people are going to do only self-interested things, but public choice presumes that incentives do matter in terms of behavior.

The bottom line is that institutions matter; that is, the way you go about making decisions is determinative in part of the outcome. And if you get bad outcomes, then the point is to change the incentives—change the institutional to change the outcomes to cause outcomes that you find more appropriate.

Mr. Moody. How does the public choice school explain the really unprecedented phenomenon—for over 200 years, we have basically balanced budgets. There has been a moral climate requiring us to do so, except for depressions or world war.

In the last 8 years, that has all gone out the window. Would the public choice explain that it has been much more pleasant to cut taxes while raising spending, which is what we have basically done?

Aggregate spending hasn't gone down as a percentage of GNP. In fact, if you count military spending, which you must, it has gone up. How does public choice explain this sort of departure in Government behavior?

Mr. Miller. That is an excellent example. It is like explaining different rates of consumption, sudden shifts, as a change in taste. Jim Buchanan—his theory is that the Keynesian revolution legitimized the running of deficits; deficits are no longer bad; in fact, deficits might well be good in certain instances.

I think it is a little more complicated than that. It has to do with the total size of Government, among other things. But in the portfolio of ways in which you can acquire command over resources—you, meaning Government, can conscript them, you can print money, you can tax, you can inflate, and you can also deficit-finance.

I mean, it is not surprising in that portfolio that deficit finance will be there. The question is how large it is going to be.

Mr. Moody. Well, it was always the most attractive option because it pushes the pain out.

Mr. Miller. Yes, but it was perceived to be very immoral. People reacted to it very strongly.

Mr. Moody. But your explanation of taste of change—you can explain anything under that ground.

Mr. Miller. Sure.

Mr. Moody. But the institutional incentives, the ones that public choice theory likes to talk about, have been more or less constant for 200 years.

Mr. Miller. That is right.

Mr. Moody. And yet we had a self-restraining governing mechanism that didn't permit us to run those kinds of deficits.

Mr. MILLER. That is right. That is an excellent point.

Mr. MOODY. Professor Summers, do you have a point?

Mr. SUMMERS. It has always seemed to me a coincidence that being interested in public choice and the political process and how it affects decisions turns out to be almost perfectly correlated with what would I think be labeled a set of right-wing, conservative, relatively anti-Government beliefs.

It seems to me there is a different kind of public choice failure in the system that you can stress equally, which is that the future doesn't vote. Children don't vote. It is not difficult to explain why sunset industries will be able to martial larger PACs than sunrise industries. They have been together to form it for a very long time.

So it seems to me that what the public choice kinds of logic would point most clearly to is a tendency for Government priorities to underweight very substantially the interests of nonvoting constituencies, of which everything about the future is, it seems to me——

Mr. MOODY. It is like rent control.

Mr. SUMMERS. Yes.

Mr. MOODY. It is like rent control. Those who aren't present and voting suffer. Those who are present have their apartments and are voting for rent control.

Mr. MILLER. I am surprised that Larry is not more familiar with the public choice literature, because if you were, you would have read many such pieces. It is just as I said in my remarks. The people who bear the burden of deficit finance—many are not even born yet. That is one reason you have in that portfolio—deficit finance is attractive.

Mr. MOODY. Well, doesn't it bother you, Dr. Miller, to have presided over the execution of those temptations?

Mr. MILLER. You mean putting together a budget that included an estimate for the deficit that was——

Mr. MOODY. Short-changed the future and short-changed——

Mr. MILLER. Absolutely.

Mr. MOODY. Short-changed education relative to military?

Mr. MILLER. Well, I wouldn't go into that discussion right now. You know, the problem with education is that you can't use your human capital for collateral. That is basically the problem with education.

Mr. MOODY. That is why public action is required. You can't mortgage it.

Mr. MILLER. Well, what I proposed, as you may well remember, got shot down by 17 antiaircraft guns. And that, basically, was the Government should provide the collateral so students could borrow rather than simply have the Government give outright grants to people to go to school.

Mr. MOODY. Well, I have appreciated the exchange. Thank you very much. Thank you.

Mr. GEPHARDT. I just have two additional questions. One, I read, Mr. Summers, what you said about the IRA's and the tax reform, and there certainly may be some truth to that.

But the current proposal, I take it, is to reduce the capital gains tax. I would like to ask each of you to respond briefly if you believe that change would increase the savings pool in the United States.

Mr. TOBIN. Well, I think the answer to that is it would not. It might, in the short run, accelerate some realizations of capital gains that maybe have been lying in wait for a better tax break. But over the long run, I think those realizations would occur some time anyway, and so we are going to lose revenue in the long run.

Losing revenue is an antisaving act rather than the reverse.

If anything is being done to the capital gains tax, I have a better idea, I think, and that is to scale the degree of tax to the length of time that assets have been held. That would mean that, let us say, if they realized within a year or 2, they would be taxed at the full income tax rate and then the rate would go down with length of holding until it might be, for 30 years or something, completely free of tax.

The point of that is to encourage people to think of long-term fundamentals when they invest in stocks rather than short-term gains. The evidence seems to be that the market is too volatile precisely because of interest in what happens tomorrow rather than what happens in the long run.

Larry has included in his list of desirable taxes a transactions tax, which has the same effect, and I would second that notion, also.

Mr. GEPHARDT. Larry.

Mr. SUMMERS. I think the 30 to 15 percent is a terrible idea. The thing that never gets said is that only 30 percent of capital gains have anything to do with corporations. Seventy percent of capital gains are Persian rugs, are real estate, are oil and gas deals, are other kinds of basically tax shelter investments.

Those, by the way—say what you like about them, and there is a lot you can say that is bad about them—are long-term investments. And so a wholesale reduction in the long-term capital gains rate would have the problem of further subsidizing those investments.

I don't think cutting the capital gains tax across the board is an efficient way at all of providing the right kinds of incentives. I think over time it would cost the Government significant revenue. It would in many cases reduce saving by encouraging borrowing.

If the capital gains tax had been at 15 percent, the Government would have lost an additional $1 billion on the RJR Nabisco deal, and that money would have gone into—the beneficiaries of that transaction would have consumed some part of it, meaning a lower level of national saving.

If we were going to do something about the capital gains area, what I would rather see done is something that only affected companies, corporate investments, venture capital, and that provided indexing so that people only had to pay on their real gains rather than on the gains that were created purely by inflation.

But it is very important that that be kept only to companies' investments because if you go back to the real estate, there is a lot of borrowing that is going to support those investments and you wouldn't want to permit favorable tax treatment of the inflation gain and not also do the same thing on the interest, but that would then be opening a whole can of worms.

So 30 to 15 is very purely targeted. The right thing to do, if something should be done, would apply only to corporate stocks and would probably be indexed.

Mr. **Miller**. I think those who conclude that the effect of reducing capital gains across the board would be to increase Federal revenue have the better part of the argument. But Larry is right; it could certainly be better targeted than just across the board.

If what you want to do is to increase the savings rate or to increase total Government revenues, you could fine-tune it in some way.

Mr. **Gephardt**. Very good. We really appreciate your time and willingness to be here today. It has been very helpful to the committee.

The committee will stand adjourned until 10 o'clock tomorrow morning.

[Whereupon, at 4:10 p.m., the committee was adjourned, to reconvene at 10 a.m., Wednesday, February 8, 1989.]

THE BUDGET DEFICIT, THE STATE OF THE U.S. ECONOMY, AND FEDERAL BUDGET POLICY FOR FISCAL YEAR 1990 AND BEYOND

WEDNESDAY, FEBRUARY 8, 1989

House of Representatives,
Committee on Ways and Means,
Washington, D.C.

The committee met, pursuant to notice, at 10:11 a.m., in room 1100, Longworth House Office Building, Hon. Dan Rostenkowski (chairman of the committee) presiding.

Chairman Rostenkowski. First of all, I want to apologize for being late. I ordinarily like to start on time, but this morning has been very hectic. Yesterday we were looking for a pay raise; today we may look for a pay reduction.

This morning, we begin our second day of hearings on the budget and the state of the Nation's economy. We will continue to discuss options for how to reduce the budget deficit and continue economic growth.

This morning, we will be discussing, in particular, the relationships between the budget and the trade deficits.

Our panel consists of witnesses noted in the field of international economics.

Gentlemen, we look forward to hearing your testimony. Mr. Bergsten, if you would like to begin. You will be followed by Mr. Lawrence and Mr. Entin.

STATEMENT OF C. FRED BERGSTEN, DIRECTOR, INSTITUTE FOR INTERNATIONAL ECONOMICS

Mr. Bergsten. Thank you very much, Mr. Chairman.

It is a pleasure to appear before the committee. I have submitted a written statement, and I will speak briefly from it to lead off the discussion.

I think the underlying economic outlook now is quite strong. The economy is close to full employment. I think we will get economic growth on the order of 2.5 to 3 percent this year. There are budding inflationary pressures, but at the moment I think they are well under control.

My principal message is that there is one major threat to the economic outlook and the continuation of the successful pattern of the last few years. That is the presence of the huge budget deficit, in particular because it is the cause of our huge trade deficit.

As you suggested, Mr. Chairman, I want to focus on the linkages between the budget and the trade deficit, and why I believe it is the trade deficit whose continuation poses the greatest threat to both our economic growth and the stability of our economy.

The trade deficit has flattened out over the last 6 months to something like $120 billion on an annual rate. The improvement of the previous 2 years has now stopped. And a series of extensive analyses we and others have done indicate that, under current policies and current exchange rates, the trade deficit will never fall below $100 billion if even that low, will start rising again either this year, or at latest, in 1990, and would be back at something like $150 billion in the early 1990's.

What that means, Mr. Chairman, is that the United States will have to keep borrowing, indefinitely, over $10 billion per month from the rest of the world to keep the domestic economy afloat, and therein lies the major threat. Even if that capital inflow were to continue, and not collapse and cause a hard landing of the economy, it would exact heavy and growing costs on our Nation, mainly because we would have to maintain very high interest rates to keep attracting that $10 billion or more per month.

I think my colleague, Dr. Lawrence, will speak on that point at great length, but I want to stress what I believe is a severe risk, namely, that if we continue to rely on foreign borrowing to that degree, and particularly if our reliance grows again—as I am suggesting it will with current policies—we could have a crash landing of the economy literally at any time, but I would say with high probability within the next couple of years.

The problem is as follows. If we have to borrow $10 billion a month from the rest of the world, we know that at any point that capital inflow can dry up. It did dry up on at least two occasions from private investors during 1987. If that capital inflow ceases again, then the dollar will plummet in the exchange markets, it could fall 20 or 25 percent, or even more.

Now that our economy is very close to full employment, the immediate effect of a plunging dollar would be a sharp rise in the inflation rate, perhaps coming close again to double digits.

Interest rates would jump sharply, well into double digits, because we would have to raise them sharply to keep the capital inflow coming back to finance the continuing trade deficits.

Obviously that kind of pattern could push the economy very quickly into an inflationary recession, which, beyond the immediate effects, could cause enormous financial disruption given the fragility of our financial system, as you are well aware.

Moreover, given that the budget in that situation would already be in large deficit, and given the inflationary picture we would have no policy tools, either fiscal or monetary, to extricate ourselves.

That scenario could happen simply if the foreign capital inflow dried up, the $10 billion a month of additional money we need, but we must never forget that foreign investors already have $1.5 trillion worth of assets in this economy, over $1 trillion of which are liquid, some of which could be withdrawn at least for extended periods of time and make the situation even worse.

So we have a kind of financial sword of Damocles hanging over the economy, and unless we start getting rid of it, by reducing and eventually eliminating our dependence on foreign investment to keep our own economy afloat, our whole economic expansion and stability could quickly go out the window.

You may say, "we have heard this story before. People have told us there was a problem of this type for several years, and we have gotten through OK." But as I mentioned, in 1987, we took some big hits. The bond market collapsed in the spring; long-term interest rates went up 300 basis points. We had Black Monday in the fall, and it had a lot to do with this problem.

So these issues that I am describing are not theoretical. Indeed I would argue that the risk of this hard landing scenario is much greater than it has ever been in the past. For one thing, over the past 5 years we have already borrowed $700 billion to finance our economic expansion. That means foreign investors are getting closer to their saturation points. We know that large Japanese investors reduced their dollar holdings considerably during 1987. That could easily happen again.

Moreover, with the economy now so close to full employment, a sharp decline in the dollar would not improve the trade balance because we do not have any resources free to push into exports and import substitution. Rather, it would lead to higher inflation, higher interest rates, and the kind of turndown that I am talking about.

What also makes the situation much more perilous now is that in the past, when private foreign investment dried up, the foreign central banks came to our rescue. Indeed, in 1987, when private foreign investment in the dollar stopped, the foreign monetary authorities, the central banks, financed our whole $150 billion deficit. I doubt we can count on their doing it again.

The other major countries—especially Germany and Japan—are now much more concerned about the pickup of inflation, because their economies are growing rapidly. If they again had to put out $150 billion to support the dollar, it would mean flooding their own economies with deutsche marks, and yen, their local currencies. That would create serious inflationary pressures. I do not think we can count on their and bailing us out in that way for the indefinite future.

The bottom line, as I see it, is that we in the United States have to restore world confidence that we will bring our foreign debt and foreign borrowing requirements down, if we are to avoid a very serious possibility of a hard landing.

And the way to resore confidence I think, is simple in concept but difficult in practice, and that is to get the budget deficit under control.

We know that the budget deficit is the main cause of the trade deficit. If you look at the U.S. economy in the 1980's as a whole, there really has been one and only one major change: On top of relatively normal levels of private spending, investment, and the like was superimposed a huge increase in the Federal budget deficit: $150 to $200 billion of net Government spending in addition to normal private sector activity.

That meant that we, as a country, were trying to spend more than we could produce at home, and the only way for that discrepancy to be met was by a huge influx of goods from abroad, and that is the definition of the trade deficit.

The rise in the budget deficit therefore caused the trade deficit. Likewise, when the Government went out to borrow $150 to $200 billion more to finance the budget deficit, it had to go abroad to find those savings because domestic savings could not generate the funds, at least not without wiping out private investment in our own economy.

That is why we shifted from being the world's largest creditor country, as recently as 1983, to being the world's largest debtor country by 1986. Our net foreign debt is half a trillion dollars. We are going to pile up $200 or $300 billion more of foreign debt, even under the most optimistic of circumstances, before we can possibly bring the problem under control.

And so, Mr. Chairman, the conclusion is a simple one. It is absolutely essential to protect the continued growth and stability of our own economy, to get the budget deficit on a steadily declining path, basically on the Gramm-Rudman schedule. That will give promise both to the markets and to the rest of the world, that we will bring our domestic spending back in line with our domestic output over these next 3 or 4 years.

I think if the Congress were to again waive or stretch out the Gramm-Rudman timetable, as you did in 1987, there would be a high probability of bringing on a crash of the dollar and a hard landing. Even if you were to rely on sequestration, which some people now talk about, the implied paralysis of governmental decisionmaking, the breakdown in the rational effort to deal with the budget, would also carry an enormous risk of that type. Therefore, I think the only politically sensible course, as well as the economically desirable course, is simply to get on with the difficult but essential business of developing a program that will credibly and effectively reduce and eventually eliminate the budget deficit, basically on the Gramm-Rudman schedule.

Even that is not going to be enough to solve our trade deficit problem, however, the other major countries have to maintain rapid economic growth. Some additional things have to be done about Third World debt. We may need a further decline in the exchange rate of the dollar, but, as I said before, a decline in the dollar without a budget package would mainly create inflation and higher interest rates, not improvement in the trade balance. Those additional things need to be done, but it all has to start from the budget deficit.

A final point, since this committee is also responsible for trade policy. There is an important trade policy dimension to this issue. Trade policy did not cause the trade deficit, and cannot eliminate it, but it has a very important role to play.

The United States needs, as I say, a trade balance improvement of something like $150 billion. To get that, foreign markets have to be open to our goods, and therefore we have to make a major effort to reduce foreign trade barriers.

We cannot take protectionist steps ourselves because in this environment where we are looking to improve our trade balance by $150 billion, other countries have to accept declines in their trade balances of $150 billion. They are going to come under protectionist pressure if we take protectionist steps. Then they will be encouraged and have an excuse to do the same thing.

Therefore, we have to promote trade expansion and opening of markets. We need to beef up, substantially, the U.S. negotiating position in the Uruguay round and the GATT. I think we should propose an elimination of all tariffs by the year 2000 and an elimination of all the voluntary restraint agreements on exports, which other countries now use to justify putting on import quotas against us. And because of the coming problem with the Europeans as they move toward 1992, we ought to explicitly extend the target date for the Uruguay round to 1992, the date by which the Europeans are aiming to complete their internal market. That will keep their feet to the multilateral fire while they are pursuing their internal negotiations on internal liberalization.

The bottom line is to avoid the risk of a dollar crunch, a hard landing of the U.S. economy, and abrupt interruption of the growth and stability we have been enjoying and continue to enjoy. You need to work on the budget deficit promptly, credibly, and decisively, to eliminate the continued huge trade imbalance and the U.S. dependence on foreign capital.

Thank you very much.

[The statement of Dr. Bergsten follows:]

THE TRADE DEFICIT AND THE ECONOMY: THE URGENCY OF ACTION ON THE BUDGET

Statement by

C. Fred Bergsten
Director
Institute for International Economics[1]

to the

Committee on Ways and Means
US House of Representatives

February 8, 1989

Summary of Conclusions

1. The huge trade deficit of the United States represents by far the greatest threat to continuing expansion and stability of our economy. The trade deficit will never fall below $100 billion on present policies and may soon start rising again. This would require us to borrow $10 billion or more per month from the rest of the world for the foreseeable future, making the United States perpetually dependent on huge inflows of foreign capital.

2. That inflow of capital could dry up at literally any moment. Private foreign investment did dry up on at least two occasions in 1987, and we cannot count on the foreign governments to bail us out indefinitely. Such a "dollar strike" is in fact quite probable within the next year or so, if not sooner, if effective action is not taken to head off renewed deterioration in the trade deficit.

3. Since our economy is now close to full employment, the resulting plunge of the dollar (which could amount to 20 percent or more) would produce a sharp increase in inflation and a sharp increase in interest rates. This would in turn provoke a recession and enormous financial disruption. Neither fiscal nor monetary policy would be immediately available to extricate the economy from such a situation.

4. It is thus urgent to adopt effective policies to head off a "hard landing." The centerpiece of such a policy must be a credible program to assure elimination of the budget deficit on the Gramm-Rudman timetable, because the budget deficit is the basic cause of the trade deficit. Another stretchout of the Gramm-Rudman timetable (as in 1987), or even a resort to sequestration, could bring on the hard landing. The political, as well as economic, costs of effective budget action are much less than the political as well as economic risks of attempting to skate through four more years of huge twin deficits.

5. Those who claim that the budget deficit is not a problem, or "simply" erodes the underlying strength and productivity of the economy over the longer run, are either ignoring the critical external dimension of the problem or blithely assuming that the rest of the world will finance us forever.

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[1] Former Assistant Secretary of the Treasury for International Affairs (1977-81) and Assistant for International Economic Affairs to the National Security Council (1969-71). This statement draws on the comprehensive analysis of the international economic position of the United States that is presented in Dr. Bergsten's new book America in the World Economy: A Strategy for the 1990s, released by the Institute for International Economics on November 10. The proposals made in this statement are elaborated in that volume.

It would be foolhardy for the United States to base its economic policy on such notions. Nor can a further decline in the dollar, by itself, or any other acceptable policy alternatives eliminate the trade deficit or even bring it down to a sustainable level.

6. The United States must also press foreign governments to further reduce their trade barriers, since most of our trade adjustment must come through increased exports. The Administration should therefore substantially beef up the US position in the Uruguay Round of trade negotiations in the GATT, *inter alia* by proposing the elimination of all tariffs by 2000 and all "voluntary restraint arrangements" on exports. The United States must avoid taking new protectionist steps itself, because other countries will be under enormous pressure to restrict our exports as they experience the huge declines in their trade balances necessary to accommodate our improvement and we should not provide any excuses for them to take such steps.

The Risk of a Hard Landing

The precarious international economic and financial position of the United States represents by far the greatest threat to the country's prosperity and stability. The trade and current account deficits have leveled off over the last six months at annual rates of about $120 billion. On current policies and exchange rates, they will never fall below (if even to) $100 billion and will start rising again in 1989 or 1990. The United States must therefore attract over $10 billion of capital per month from the rest of the world.

These huge external deficits would exact heavy and growing costs on the US economy even if a hard landing were never to occur. Instead of earning $30-40 billion annually on our foreign investments, which we did as recently as 1980-82, we will soon be paying like amounts to the rest of the world; these payments would keep rising if the deficits continue, thereby draining an increasing amount of resources from our own economy.

To achieve that transfer, we would have to restrain the growth of domestic spending to an increasing extent. We would have to accept a steady weakening of the exchange rate of the dollar, thereby reducing our national wealth and income, to run the stronger trade balances required to affect such a transfer. And we would almost certainly have to maintain much higher interest rates indefinitely to keep the capital inflow coming--thereby permanently dampening domestic investment, and with it the prospects for faster productivity growth and higher standards of living.

However, in addition to these long-term corrosive effects of the external deficit, there is a severe risk that it could bring on a hard landing of the economy within the next year or so--if not sooner. Whenever the capital inflow dries up, the dollar plummets. With the economy now at or near full employment and full capacity utilization, such a fall of the dollar would push our inflation rate up sharply--perhaps close to double digits.[2] Interest rates would jump well into double digits, rising along with inflation but going considerably higher as the Federal Reserve was forced to drive up real rates to counter the inflation pressure and keep the dollar from dropping even more.[3] The economy would fall quickly into recession. The situation would be even worse if foreign investors withdrew some of the $1.5 trillion of liquid assets which they already hold in the United States.

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[2] Every 10 percent fall of the trade-weighted exchange rate of the dollar tends to raise the price indices by about 1.5 percentage points. With inflation now expected to run 4-5 percent in 1989-90, a 20-30 percent fall in the dollar could push that rate to 7-10 percent.

Some observers rightly note that these concerns have been expressed for several years but that no crisis has emerged. However, we have already borrowed $700 billion over the past six years, and foreign investors are therefore much nearer their saturation points for dollar holdings. We know that some major categories of private Japanese investors, for example, reduced their holdings here by billions of dollars in 1987 and cut them again during some months in 1988.

Moreover, there is nothing theoretical about this "hard landing" scenario. Its first steps occurred twice during 1987. In the spring, a drying up of private capital inflows pushed the dollar down sharply and triggered a rise of three percentage points in long-term interest rates. In the fall, market fears of a repeat performance were the primary cause of the sharp fall of the stock market.

The central banks came to the rescue on both occasions, before the market hits could devastate the real economy, and financed almost all of our $150 billion deficit in 1987. But these "warning shots across the bow" revealed the vulnerability caused by our external debt and deficits. Indeed, Secretary Baker had to halt his efforts to achieve additional improvement in our trade balance through further dollar depreciation in order to elicit the required foreign support.

The crisis remained in suspended animation through much of 1988 because the central banks, knowing that budget action here was impossible in an election year, resolved to intervene as much as necessary to prevent a free fall of the dollar. The private investors became aware of that guarantee and, encouraged by the decline in the trade deficit through midyear and a rise in US interest rates, again invested large amounts in the United States. But the dollar weakened again sharply just before and after the election, approaching its all-time lows, as doubts emerged over the resolve of the newly elected President to address the problem. Conversely, it strengthened in recent weeks as the outlook for budget action seemed to improve and, in particular, as interest rates moved up again.

The bottom line, however, is that the world may well give up on the dollar if it foresees four more years of towering twin deficits. In the absence of new policy steps, as noted, our external deficits will remain above--perhaps well above--$100 billion. They will soon start climbing again (and the latest monthly data suggest that renewed climb may have already begun). Our net foreign debt could easily rise to $1 trillion by 1992.

Given such an outlook, foreign investors could simply decide to stop making new investments in the dollar--or even liquidate existing investments. Even if they want to hold more dollar assets over the longer run, they could easily "park" their funds in other currencies for long enough to destabilize our currency. American investors could flee the dollar as well.

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[3] Real interest rates could rise 3-5 percentage points in this scenario. Coming on top of the hypothesized rise of 3-5 percentage points in the inflation rate, and thus in nominal interest rates, this could take rates to 14-20 percent from their current levels of 8-10 percent.

Nor can we assume that foreign monetary authorities will again save the day. With their economies now growing much more rapidly, their concerns about losing export markets--which would result from a further decline in the value of the dollar against their currencies--have diminished considerably. Inflation is again the paramount policy concern in Germany, and is of increasing worry in Japan; these key central banks therefore now have particular fear of the inflationary consequences for their economies of massive intervention to defend the dollar, and they recall that such intervention was a major cause of the global inflations of the early 1970s and late 1970s. They may simply be unwilling to finance an indefinite continuation of excessive American spending.

The impact on our economy of a sharp fall in the dollar would be far greater than even a year or two ago. The advent of full employment means that the inflationary effect would be much larger and quicker than in 1985-87, when unutilized domestic resources permitted much of the contemporary fall of the dollar to be translated into considerable trade improvement instead. The financial disruptiveness of an inflationary recession with high interest rates would be much greater because of the fragility of the financial system caused by the collapse of many thrift institutions, the continuing difficulties of some banks in the Southwest and elsewhere, the sharp increase of corporate debt due to the wave of leveraged buyouts, and the increased risk of Third World defaults.

Finally, there would be no ready escape from the induced recession. The budget deficit would be far too large to permit an injection of new fiscal stimulus. Monetary policy would for some time have to remain conscious of countering inflation and avoiding an even further slide of the dollar. The hard landing could be prolonged as well as deep.

The Budget Deficit and the Dollar

The greatest risk of a hard landing derives from the risk that the Administration and Congress will fail to come up with a credible and effective program to eliminate the budget deficit. Conversely, adoption and faithful implementation of such a program should effectively preclude such a scenario, and place the economy on a stable and highly promising course for the 1990s.

The sharp increase in the Federal budget deficit from 1981 to 1986, coupled with roughly normal levels of private consumption and investment, meant that the United States as a country was spending more than it was producing at home. The only possible reconciliation was a huge inflow of goods from abroad--the trade deficit. That deficit had to be financed by an equivalent capital inflow from abroad, transforming the United States from world's largest creditor country as recently as 1983 to world's largest debtor by 1986.

Likewise, the huge increase in government demand on the capital markets used up most of our extremely low level of net private saving. During 1985-87, the Federal budget deficit ate up over 85 percent of net private saving. Very little was left to finance private investment, the chief engine for increasing productivity and thus for raising our standard of living. (The decline in domestic private saving, contrary to the promises of the so-called "supply siders," made the situation even worse.) This required the huge inflow of capital from abroad which has so greatly increased our vulnerability to the decisions of the world's financial markets.

Elimination of the external deficit, and its financial requirements, requires elimination of the excess of domestic spending over domestic production. That could be accomplished by trimming private investment--but we need more of such investment, both to provide capacity for export expansion and to improve productivity more generally. It could occur through an autonomous decline in the share of private income devoted to consumption and a concomitant rise in the private saving rate--but the trend has been running in the opposite direction. A recession would of course reduce the trade deficit, by cutting demand for imports along with everything else, but that would be the highly undesirable effect of the hard landing which policy must seek to avoid.

We do not need a recession to cure our trade imbalance. We do need a shift in the composition of economic growth away from government spending and private consumption toward exports and supportive private investment. At the moment, despite the enormous improvement in US price competitiveness due to the large fall of the dollar, domestic demand continues to grow so rapidly that some firms are turning down (or rationing) export orders and imports continue to rise rapidly.

The only way to make this shift possible without undesirable side effects is to eliminate the budget deficit. This will reduce government expenditure directly, and restrain private consumption by raising taxes and/or reducing transfer payments to individuals. Along with the complementary currency changes and other international steps outlined below, elimination of the budget deficit would thus permit elimination of the external deficit.[4]

The economy could continue growing at about 2 1/2 percent per year, about the maximum that is possible now that we are near full employment. About 1-1 1/2 percent of that growth would come from improvement in the trade balance, as actually occurred in the first half of 1988.[5] About 1/2-1 percent would come from rising private investment. Only 1/2-1 percent would be available for further increases in private consumption and government spending, so that per capita consumption would grow very slowly if at all during the adjustment period--after its rapid 3-4 percent growth, financed in essence by foreign capital, during the past six years.

An effective attack on the budget deficit would remove the financial Sword of Damocles now hanging over the economy. Market perceptions of a steady decline in the American borrowing requirement, especially from abroad, would encourage the net capital inflows (of at least $200 billion) which will continue to be needed as our deficits continue, albeit at a declining level, throughout the adjustment period. Interest rates would fall, perhaps by several percentage points. (The events of 1985-86 show that large capital inflows are consistent with declining interest rates--and a falling dollar--if confidence is maintained in underlying economic policy.) The expansion would continue, led by the improvement in the trade balance and a supportive increase in private investment (spurred by the lower interest rates).

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[4] Elimination of the budget deficit would free up just about the amount of domestic resources needed to expand exports enough to eliminate the current account deficit. The two deficits were almost identical in magnitude (at about $150 billion) in 1987. In 1988, the budget deficit was probably about $25 billion greater--but the volume improvement in the external imbalance will need to be greater than the value improvement because the decline in the exchange rate of the dollar raises the price of imports as it reduces their volume.

[5] The trade balance flattened out in the second half of 1988, in real GNP terms as well as in dollar terms, and had a slight negative effect on overall growth.

The Nature of the Budget Package

I will not suggest a detailed program to eliminate the budget deficit. However, several criteria which should govern the selection of specific measures derive naturally from my emphasis on putting the external deficit on a path of assured correction and avoiding the risk of a hard landing.

First, the Gramm-Rudman timetable must be met. Any alteration in the agreed targets, as occurred in 1987, could on this occasion bring a collapse of confidence in the markets and trigger the hard landing.

Second, it will be essential to maintain steady progress toward the ultimate adoption of an effective package. Any appearance of a breakdown in the negotiations, or even of significant backsliding, could trigger considerable market instability.

Third, reliance on sequestration to meet the targets would be extremely risky. Sequestration would imply a breakdown in the negotiation approach, and would be read as an indicator of paralysis in the American decisionmaking process. It would not be as bad as waiving the targets, but the path to sequestration could also produce a hard landing.

Fourth, elimination of the budget deficit is more important than the specific means through which that elimination is achieved. It is essential to overcome the interminable squabbles of the past few years over the distribution of budget improvements, and move with all deliberate speed to the bottom line. This of course means that all parties to the process must be prepared to make compromises from their previous positions.

Fifth, the new fiscal program must be fully credible at the outset. It must thus be based on real savings rather than asset sales, accounting gimmicks and other devices which are more likely to undermine than sustain investment flows. The United States will have to import at least $200 billion of additional capital over the next four years even under the most optimistic adjustment scenario, so retention of confidence is absolutely essential through this period.

Sixth, in order to be credible, the fiscal measures must phase in with increasing impact over the four-year target period.[6] This calls for Congressional action in 1989 that will lock in the deficit improvement through 1992. The budget measures should thus be of a type that can be put into place irrevocably (barring overt reversal by subsequent Congressional actions) and that have an accelerating impact on the deficit. Examples include changes in major weapons programs, in the payments formulas under the large entitlement programs, and in most tax increases.

One example is an additional tax on gasoline, which could be phased in at a predetermined rate over the next four years. If that rate were set at 10-15 cents per year, the measure would provide assurance of raising about $50 billion of additional revenue by 1992--thus achieving about one third of the needed budget correction. A gasoline tax would also provide enormous direct leverage on the trade deficit: every dollar of reduced demand for oil in the United States leads to a reduced dollar of oil imports, because domestic output is now flat or falling and all marginal demand is met from foreign sources.

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[6] Beyond the existing Gramm-Rudman timetable, adoption of a four-year target to eliminate the external deficit is highly desirable because it could be achieved during the term of a single Administration--and would thus be much more credible than a target which extended into a future Administration.

Seventh, any changes in tax policy should aim to increase the domestic saving rate and dampen the high national propensity to consume. As indicated above, this would free resources for an improvement in the external position and reduce our dependence on foreign capital in both the short and longer runs. Consumption taxes, whether across the board or on specific sectors (such as gasoline), would thus be superior to higher marginal tax rates. Equity issues arise with such taxes, but can be dealt with in constructing them and should not deter their consideration.

The International Dimension

Even if the United States were to adopt and implement a budget program as recommended, it cannot eliminate its external deficit solely through domestic actions. The major foreign countries, particularly those whose surpluses mirror our deficits, must:

- -- maintain sufficient domestic-led growth in their economies, of at least 5 percent annually in Japan and 3 percent in Europe, to provide markets for our exports;
- -- avoid any new trade barriers and reduce those which still exist, through bilateral negotiations but primarily through a successful Uruguay Round of multilateral negotiations in the GATT (see below);
- -- cooperate with us to reduce the debt burden of Third World countries, so that these countries can resume economic growth and *inter alia* buy more from the United States;
- -- work with us to achieve an equilibrium level for exchange rates, including a further substantial rise in the Japanese yen and the German mark, and then to maintain those rates (preferably via the adoption of target zones) so that American exporters will not again be priced out of world markets.

Once an effective budget program is developed here, it would therefore be highly desirable to seek prompt agreement from the other major countries that they will do their part on all these fronts to assure the desired outcome. *Such a pact would be a natural focus for the Economic Summit scheduled for July*, or an earlier meeting if the timing of the process would permit. Favorable market reactions and the prospects for faithful followthrough could be maximized by such a global accord.

The Exchange Rate as an Alternative?

Some observers have argued that a decline in the exchange rate of the dollar could, by itself, correct our trade deficit and thereby avoid the risk of a hard landing. I share the view that a further decline of the dollar--probably on the order of about 15 percent on average, focused primarily on the surplus countries (notably Japan and Germany) and held in place subsequently by adoption of a system of currency target zones--will be needed to fully balance our current account position. But *a decline in the dollar now, in the absence of a budget correction or alternative steps to reduce domestic demand, would primarily lead to higher inflation and might not improve the trade balance at all*.

The reason is that, as noted above, the economy is now close to full employment. A further decline of the dollar would further enhance the competitiveness of American exports, and the appeal of domestic goods relative to imports. However, in the absence of unused domestic resources to meet such demand, prices would be driven up across the board. That increased inflation would in turn offset most or all of the competitive gains from the decline in the dollar, and obviate any significant improvement in our trade balance.

It would therefore be a mistake to believe that a further decline in the exchange rate of the dollar could by itself solve the trade problem and obviate the major risks now facing the economy. Indeed, such a decline could bring on the hard landing. *There is no escape from the need for an effective budget program*.

Trade Policy and the Trade Deficit

In view of the Committee's responsibility for trade policy, I would like to add a few words on that subject. Foreign trade barriers obviously did not cause the US trade deficit, because no conceivable rise in such barriers could have produced the deterioration of over $100 billion in our trade balance in the 1980s. Indeed, American trade barriers may have risen faster than foreign barriers during this period.

Nevertheless, significant foreign barriers to our exports clearly exist and must be diligently attacked as part of any comprehensive effort to correct our trade imbalance. Most of the needed improvement of about $150 billion in our position must come from export expansion, and we must have full access to markets abroad to permit that expansion to take place. We can only take full advantage of the enormous improvement in our international competitive position, stemming in large part from the decline in the dollar, if foreign markets are open to our products.

One implication of this situation is that the United States must avoid protectionist measures during this period. Other countries must accept huge declines in their trade balances to accommodate our improvement, and they will therefore come under enormous protectionist pressures during these new few years. This will be especially true in Europe, as they simultaneously face deteriorating trade balances and the political imperative of eliminating barriers to intra-EC trade. Any protectionist steps by the United States in this environment would encourage and justify market closure abroad, rather than market opening, and we must not provide other countries with such an excuse.

Beyond avoiding new protection, however, we need to push hard for renewed trade liberalization abroad. The most effective way to do so is through a successful outcome of the Uruguay Round of negotiations in the GATT, and the new Administration--in close consultation with the Congress--should substantially beef up the US negotiating position in an effort to do so. I would recommend that we propose several steps to that end:

- Elimination of all tariffs on industrial trade among industrial countries by 2000 (which would *inter alia* eliminate the discriminatory effects of the Common External Tariff of the European Community).

- Elimination of all "voluntary restraint arrangements" (VRAs) and other "gray area" trade measures not now covered by the GATT, in return for firm commitments by other countries--both industrial and developing--to a new Safeguard Code that will avoid recourse to new trade barriers. These VRAs are bad for the United States in any event: by giving the exporting countries the right to allocate the quotas, they transfer billions of dollars of windfall profits to our major competitors abroad and enhance rather than weaken their competitive position.

- Extension of the target date for the Uruguay Round to 1992, to coincide with the EC's target date for "completion of the internal market." This would enable us to hold the EC's feet to the multilateral fire throughout its process of internal negotiation, reducing the risk that it will forget about its global obligations and do internal deals at the expense of the rest of the world.

Conclusion

The American economy stands at a rare historical crossroad. Responsible action on the budget, along with a series of related steps on trade policy and the other issues discussed above, can correct the major flaw in the economic legacy of the 1980s and provide the foundation for stable prosperity in the 1990s. Failure to take such action, however, can throw us back to the stagflation of the 1970s--or worse.

The United States has enjoyed extraordinary economic success over the past six years. Our prosperity and stability were achieved in large part, however, by borrowing $700 billion from the rest of the world. This borrowing binge has another $200 billion to go even under the most optimistic of adjustment scenarios, and much larger amounts will be required in the absence of effective adjustment measures.

It would be the height of folly to try to skate through four more years, or even one or two, with continued foreign borrowing on the current scale of $10 billion or more per month. Indeed, the world may give up on the dollar in the very near future--and force a hard landing on our economy--unless we give clear signs of bringing down the twin deficits.

History reveals that such huge imbalances always require adjustment. The only issues are when and how that adjustment takes place: preemptively and constructively, or in reaction to a crisis after enormous costs have been suffered by the people of the country involved. There is still an opportunity to make a conscious choice in favor of constructive adjustment, but time may be short and the process must begin without delay.

Chairman ROSTENKOWSKI. Thank you, Mr. Bergsten. Before I ask Dr. Lawrence to testify, I would like to apologize for not introducing Dr. Ture. Norman, I am very happy that you are feeling better today and I am very grateful for you to join us.

Dr. TURE. Thank you, sir.

Chairman ROSTENKOWSKI. Dr. Lawrence.

STATEMENT OF ROBERT Z. LAWRENCE, PH.D., SENIOR FELLOW, THE BROOKINGS INSTITUTION

Mr. LAWRENCE. Thank you, Mr. Chairman.

As we look back over the period of the 1980's, I think historians are going to regard our behavior as one which demonstrates a very ironical outcome.

In the early 1980's there was a national consensus in this country that we were saving too little. At the time, we were saving, on balance, about 7 percent of our gross national product.

We implemented a set of policies which were allegedly designed to raise our Nation's savings rate, and what is striking is that this year, and last year, we were saving at the rate of something like 3 percent of our national incomes.

The net result is a dramatic decline in this Nation's savings rate. Essentially since 1980, the United States has been on a consumption binge. Our spending has grown at a rate of about 2.2 percent per year on a per capita basis.

Our production, unfortunately, has been rising at 1.2 percent, and what we have been doing is borrowing from the rest of the world to finance that difference.

So I think that our fundamental problem is essentially one of an imbalance in our spending patterns. If you read the literature and the discussion about our current situation, however, you will find a number of arguments that suggest that we do not have to do anything about the situation. That it is not as serious as it appears.

What I do in my testimony is to review these arguments, and essentially to reject them.

One argument that you will hear quite often is that our Federal budget deficit is measured with great error. We do not take account of the effects of inflation.

Another argument that you will hear is that our net international investment position is measured with great error, again distorted by the effects of inflation and exchange rates.

I would agree, that we do not have a very precise measure of the level of our Federal budget deficit, or of our net international investment position.

But what I think is so striking, and not subject to any measurement error, is the direction in which the Federal budget deficit has changed since 1980, and the direction in which our net international investment position has changed since 1980.

And those I think cannot be disputed. No one would deny that this country has lowered its savings rate.

Some, however, would suggest that we do not have to worry about our current situation because we are borrowing the money in order to finance investment.

But in fact again, I think, unfortunately, if you look at the data you cannot support that argument. If we had had our national savings rate at its historic average of around about 7.5 percent of gross national product, we could have funded the entire value of our investment last year, which was about 5.4 percent of our GNP, fully through our domestic savings.

And instead of borrowing $130 billion from the rest of the world, we could have actually had a surplus of around $100 billion, which we could have lent to the rest of the world.

So we do not have an investment boom in this country. We have, rather, a savings bust.

A third argument is to say that we do not have to worry about this current situation because foreigners are lending to us. In essence, it demonstrates the confidence in the rest of the world in the United States.

Well, I would submit that simply because others are willing to lend is not an argument for us to borrow. Every week, I am sure you, like me, receive another application form for a credit card.

You could take advantage of those applications and go on your own consumption binge, and I do not think it would be a very persuasive argument to excuse your behavior, simply saying you are entitled to spend because MasterCard is willing to lend.

I think, rather, we should look more closely at our own situation. Now I happen to disagree with Mr. Bergsten in terms of the stress he places on the likelihood that our current situation will shortly result in some kind of a financial crisis.

I would not rule it out, but, at the same time, I think there is better than even chance, that we could go on the way we have for an extended period of time.

I think our problem—to paraphrase a statement of my colleague, Charles Schultze—is not the wolf at the door, but rather, the termites in the woodwork.

We have a long-term problem rather than a short-term one. After all, we are saving 3 percent of our national income. It is not enough to fund the investment we carry out in this economy, but it is a positive number, and we could go on like this, I think virtually indefinitely, and certainly for the next 3 or 4 years.

But I think we should ask ourselves whether this is desirable. What has happened since 1980 that justifies our national savings behavior? When I think about our situation, I am led to conclude that two major factors should lead us to want to save more, not less.

The first is the decline in productivity growth that we have seen in this economy since 1973, and while we do not understand that decline very well, the experts do agree that an increase in investment would help, and an increase in investment would be stimulated, in turn, by a rise in our national savings rate.

The second reason to worry about our Nation's savings rate is of course demographics. Our demographic situation is changing, and as the baby-boom generation reaches retirement age, around the year 2010, it would be nice if our Nation's capital stock was larger than it appears it is going to be.

This is, in essence, a long-term problem that we face, but it is critical that we take steps today to deal with it.

My own view is that we should indeed place a priority in raising the Nation's savings rate, and that it should be the Federal Government that bears most of the burden.

We could rely on the private sector, and private savings to suddenly reverse its declines, but I, for one, would not rely on that.

I do not see much evidence to see that the private savings rate is picking up. So I think it is up to the Federal Government to save for the Nation.

My own view is that we should raise our national savings rates to an objective along the lines of the Gramm-Rudman, something like a balance by the 1993 date, and then we should move further, to try to generate a balance, excluding the Social Security fund and the other retirement funds.

This seems like an extremely ambitious goal today, and yet, it would simply raise our Nation's savings rate to around the 8 percent rate that we were saving in the 1960's.

And I think that that kind of rate would be adequate to fund the sort of investment we need, and indeed, would allow us not to have a trade deficit, but, rather, to be lending to the rest of the world.

Now to do all this I think we will have to cut spending, but I also believe it is going to be necessary to raise revenues. I personally favor taxes which zero in on consumption, since I do believe our chronic problem is a savings one.

I would favor a value-added tax, an oil-consumption fee, and perhaps even disallowing the mortgage interest deduction.

I think we should recognize, however, that we do have twin deficits, and in fact these are Siamese twins. There is a connection between the two of them. And it is critical, as we look out into the future, that we realize that the smooth adjustment of our economy requires bringing these two deficits down in tandem.

If we were to bring the trade deficit down too rapidly, either because the exchange rate were to depreciate further, or we would embark on some protectionist measures, or in fact we were to try to prevent foreign investment in this country, if that were to occur our economy would shift into an inflationary situation, because when the trade deficit improves it injects purchasing power into economy.

At the same time, if we were to bring down our budget deficit too rapidly, we could move the economy into a contractionary phase. So the key thing is to try to bring down those two deficits, those two twins, in tandem, in order to keep the economy on an even keel.

I think therefore, it would be folly to try to simply improve the trade deficit, to bring down the dollar, without taking the necessary offsetting effects, by withdrawing purchasing power through the budget deficit.

I would also finally say that I think that taking care of the budget deficit problem would have other benefits in addition to raising our long-term savings rate.

I would agree with Fred Bergsten, that it would materially reduce the likelihood of a financial market crisis. I do not think that is likely, but it certainly is possible.

I think, second, it would restore our ability to use fiscal policy to stabilize our economy. In 1982, in the recession, we were free to enact tax cuts. In the next recession, we would not have that freedom if we have this large structural, fiscal imbalance.

I think, thirdly, it would materially improve our competitiveness. It would leave room for the dollar to decline, and that, in turn, would help our performance in international trade.

So let me conclude by saying I would be happy to answer your questions on this and any other subject. Thank you.

[The statement of Mr. Lawrence follows:]

Statement of Robert Z. Lawrence*
Senior Fellow, The Brookings Institution
before the
Ways and Means Committee
U.S. House of Representatives
February 8, 1989

The Impact of the Federal Budget Deficit on the Nation's Economic Future

It is one of history's great ironies. In the early 1980s there was a national consensus that the 6.9 percent of income the United States had saved during the Carter years was too little. The Reagan administration responded by proposing policies to increase saving and investment. But the policies actually raised public sector borrowing, and despite the incentives provided for higher private saving, the U.S. personal saving rate continued to plunge. As a result, as indicated in Table 1, the U.S. net national saving rate fell to postwar lows. During the Reagan years, net national saving has been a scant 2.8 percent of GNP — less than half the unsatisfactory rate in the late 1970s. In 1988 (as shown in Table 2) although the share of net national investment in GNP was below its average during the Carter years, the U.S. was unable to finance more than half of it through domestic saving.

Indeed, since 1980 the United States has been on a consumption binge: spending by consumers and the government has grown at an annual rate of 2.2 percent per capita. The experience has been pleasurable. Tax cuts have bolstered spending power, cheap imported goods have cut the rate of inflation and unemployment has fallen to levels last reached in the early 1970s. But there has been a downside. Americans have bought more than they produced and provided the difference through the trade deficit which grew more than $130 billion between 1981 and 1987. The trade deficit has caused a wrenching realignment of U.S. industry as many companies were priced out of world markets in the mid 1980's. To finance the gap between spending and income, the U.S. has been borrowing from abroad. The U.S. international investment position has shifted from that of net creditor of $141.2 billion in 1981 to net debtor of about $500 billion today — a swing of over $600 billion in just seven years. Increasingly, therefore, the pleasures of the spending binge are being tempered by a recognitions of its costs: a loss of world markets and the burden of debt placed on future generations.

But changing U.S. spending patterns will be painful. To bring its spending in line with production, the U.S. economy will have to engage in considerable belt-tightening. Goods and services once available for domestic use will have to be exported or used as a replacement forimports. To sell these U.S. products abroad a weaker dollar will be required. This will further reduce U.S. buying power. To cease foreign borrowing by 1995, I have estimated that U.S. per capita spending can only grow at 0.7 percent per year over the next seven years — a much slower rate of increase than at any time in the postwar period, and far below the growth rate of the last seven years.

The temptation to delay adjustment is considerable. There are numerous apologists for our current spending patterns. In this testimony I will explain why I reject their arguments and indicate why reducing the Federal budget deficit should be given the highest policy priority.

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*The responsibility for this statement is mine alone and does not reflect the views of the Brookings Institution, its officers, trustees, or other staff members.

1. See Robert Z. Lawrence, "The International Dimension" in Robert E.Litan, Robert Z. Lawrence and Charles L. Schultze, eds., U.S. Living Standards: Threats and Challenges (Brookings Institution, 1989).

Why Worry?

(1) Mismeasurement. Some argue the official data are misleading and exaggerate our problems. We need not be concerned about our current situation, because our national saving rate, net international investment position and the federal budget deficit are all incorrectly measured. In particular the official measures fail to account properly for the effects of inflation. But even if there are errors in the levels of these measures there is no question about the direction in which they havechanged. If the U.S. national saving rate was about right in 1980, it is too low today. If our budget deficit is actually smaller than we report, it is nonetheless much larger than it was in the early 1980s. Maybe our international net investment position is stronger than reported officially, but it is much weaker today than before we ran the large trade deficits in the 1980s. This can be seen from our net investment earnings. Our net foreign investment income which was $34 billion in 1981 has declined to a deficit of around $0.3 billion in the first three quarters of 1988.

(2) Investment boom. Not all borrowing is bad. If someone borrows to finance their education or acquire an income-earning asset, they might reduce rather than raise their debt-service burdens in the future. Some have, similarly, taken a sanguine view of U.S. foreign borrowing, because it has allegedly financed an investment boom which will help service the borrowing in the future. But the data simply do not support this viewpoint. As indicated in Table 1, in the first three quarters of 1988, the U.S. spent 5.4 percent of its GNP on net investment. Had we saved at our 1950-80 average of 7.5 percent of GNP, domestic investment in 1988 could have been entirely financed domestically. Indeed, our 1988 investment level could have been accompanied by a surplus in net foreign investment of about 100 billion dollars.

Those who believe we have an investment boom like to quote our real gross investment levels. But (1) we borrow in current not constant dollars from abroad; (2) in estimating our future productivity we should take account of the depreciation of capital; and (3) in any case, as indicated in Table 3, the ratio of real gross domestic investment to GNP was actually higher in the Carter years than the Reagan years (17.5 versus 17.0 percent).

(3) Foreign confidence. Today, foreigners are happy to lend to us. In 1989, private foreign investors have been willing to accumulate U.S. dollar obligations despite the fact that real long term interest rates in the the United States are quite similar to those in Europe and Japan. Apparently, investors are willing to hold U.S. dollars rather than German Marks or Japanese Yen with no greater compensation than the inflation differentials between these countries and the USA.

The United States remains creditworthy. We may be the world's largest net debtor, but U.S. international obligations appear small when compared with U.S. national income or wealth. Even ignoring income from U.S. assets abroad, the $83 billion the U.S. paid on its international debt in 1987 represented less than two percent of GNP and only 20 percent of the exports of goods and services. In contrast, the average debt service ratio in the non-oil countries of Latin America was 47 percent at the time the debt crisis erupted in 1982. Furthermore, unlike debts of the typical foreign borrower, much U.S. debt is denominated in the borrower's own currency — U.S. dollars.

But the fact that foreigners are willing to lend, does not imply that the United States should borrow. Almost every week, I am sure, members of this committee receive offers of a credit card in the mail. There are many who want to lend to you at no more than the going rate. For some time, you could accept these offers and go on a consumption binge. It would surely not be adequate to excuse your behavior on the grounds that Mastercard is willing to lend.

(4) Our spending patterns are sustainable. The fourth reason for doing nothing is that the current situation appears sustainable. In 1985 one could have argued that with the dollar at 250 yen and 3.50 marks the U.S. trade deficit and international borrowing were on an explosive path. But if the current account deficit persists at today's level of about

three percent of GNP, U.S. net debt in 1993 would be about 18 percent of GDP and net interest payments would be just 0.7 percent of income and 7 percent of exports. These are not the ratios of a debt crisis. Similarly, the budget deficit is nearing the level at which government debt will rise about as rapidly as GNP — keeping the debt-to-GNP ratio constant.

While some have questioned the sustainability of our current situation, and believe the U.S. is likely to face a crisis in the financial markets soon, I happen to concur with the view that our current situation is probably sustainable. We could probably get away with taking minimal steps to reduce our twin deficits without major immediate consequences. From time to time our spending patterns might be associated with downward pressure on the dollar, but this could be dealt with by raising interest rates to attract foreign capital and/or borrowing in a foreign currency. Indeed, the major concern of foreign investors who lend to the U.S. is not U.S. solvency but the foreign exchange risk they assume by holding dollars. The U.S. could alleviate such concerns and avoid the need to pay higher dollar interest rates by borrowing in foreign currencies. Of course if the dollar fell, eventually this procedure could be more costly to the Treasury, but it would be an effective way of delaying the eventual day of reckoning.

Indeed, it is precisely because delay is possible that the decisions you will have to take are so difficult. As one of my colleagues, Charles Schultze, has put it, "Our problem is not the wolf at the door but rather the termites in the woodworks." Our current situation is sustainable even it is not desirable.

(5) Our spending patterns are desirable. Some argue the government should not interfere with the choices made by private U.S. citizens. If private U.S. citizens want to live well today and less well tomorrow, that's their choice. But given the responsibilities it has assumed in our society, in particular the importance of the government budget deficit and its role in providing for retirement, the government cannot afford to be indifferent to the national saving rate.

In the novel by Charles Dickens, Mr. Micawber defines happiness as living within your means. "...if a man had twenty pounds a year for his income, and spent nineteen pounds nineteen shillings and sixpence, he would be happy, but that if he spent twenty pounds one he would be miserable." But Mr Micawber's was surely a minimal standard. We may not be on the unsustainable path of actually reducing our national wealth, but we are currently on a path along which which it will rise much more slowly than it used to. With a net national saving rate of 3 percent of GNP, we, and the generations that follow us, will be better off in the future than we are today. The question however, is whether we should be satisfied if today Americans save at only about half the rates they did for most of the postwar era.

In my view, there are two major reasons why we should not. The first is the slump in productivity growth that has occurred since 1973. While much of that slowdown remains a puzzle, experts agree that higher rates of investment will help raise productivity growth. Increased national saving helps stimulate such investment. The second reason is demographics. Around 2010 the postwar baby-boom generation of Americans will begin reaching retirement age. The nation should be taking actions today which ensures they will be adequately taken care of.

How much should the U.S. be saving? One goal is for the United States to aim, by the mid 1990s to have sufficient domestic savings to finance its net domestic investment spending. Given the 5.4 of GNP constituted by net domestic investment in the first three quarters of 1988, this would require raising national saving by 2.5 percent of GNP or roughly the size of the federal budget deficit in 1988.

However, such a goal would be about one percent below the average investment rate between 1950 and 1980 which many have argued was inadequate. Without additional declines in the price of capital goods, we would be unable to finance our historic rate of real net capital formation.

A second, more ambitious goal which I favor, would be to raise national savings to around eight percent of GNP by the late 1990s. By the mid 1990s, the annual surpluses of social security will amount to about two percent of GNP. Given the current private saving rate and the ratio of local government surpluses to GNP, if the federal government achieved a rough balance in the Federal budget, excluding the social security and other government retirement trust funds, the U.S. national saving rate would be about 7.7 percent — or roughly its level in the 1960s. This level of saving would allow the U.S. to raise net national investment rates back to the seven percent rates typical of the past and to run current account surpluses.

Of course, if private saving rates were to recover, this national objective would be compatible with a smaller Federal budget surplus. A rise in the future private saving rate because of demographic or other reasons, cannot be ruled out, but it should not be relied upon. Currently there is little evidence of such a surge but it would not be too painful for Congress to raise government spending or reduce taxes in the face of such an eventuality.

I believe the Federal government itself should save through the budget rather than reducing government revenues in trying to induce higher private saving by changing the incentives to save. Indeed, private saving does not appear highly responsive to incentives to save. In particular, there have been numerous developments in the 1980s which might have been expected to raise private savings. Despite increased tax incentives for savings (IRA accounts), lower marginal tax rates, higher real rates of return, and an aging of the baby-boom, the personal saving rate has plunged. Some economists believe higher government deficits will induce a rise in private savings as far-sighted citizens anticipate future tax hikes. But their forecasts of a private offset for federal budget deficits in the 1980s have not been correct.

If the nation as a whole is to save more, therefore, most of the effort will have to be made by the federal government. This suggests a long term goal of a balanced federal budget — excluding the retirement trust funds — would be an appropriate national saving objective.

(5) Deficits are better than less spending or more taxes. There are some, typically on the left, who believe that reducing the deficit by cutting spending on public investment would be worse than allowing it continue at current levels. On the other hand, there are those, typically on the right, who prefer large deficits to higher taxes, because they argue that the government inevitably raises spending when it has higher revenues. Both arguments have an element of truth, pointing to the importance of how we reduce the deficit. But neither objection really justifies inaction on the budget deficit. In balancing the budget, Congress should obviously eliminate programs which represent consumption rather than investment. Similarly, it would be folly to raise revenues only to turn around and spend them on additional consumption.

It would be beyond the scope of this testimony for me to try to lay out a detailed budgetary program. While I hope, particularly given recent developments in the Soviet Union, that major deficit reductions on the spending side will be possible, I also believe it will be necessary to raise revenues to meet the Gramm-Rudman targets. My preference would be for taxes aimed at consumption — a gasoline consumption tax or a value-added tax or for raising revenues by denying the tax deduction for mortgage payments.

Adjustment Pace. Those who recognise the dangers of delay may argue for prompt, vigorous action — for sudden adjustment. If foreign borrowing makes the U.S. economy vulnerable, why not bring it to a speedy halt by lowering the value of the dollar through intervention or expansionary U.S. monetary policy? Alternatively, why not tax foreign borrowing, restrict foreign investment, or reduce the trade deficit through quotas or tariffs.

These responses are inappropriate because they treat the symptom of excess national spending — the trade deficit — rather than the underlying cause — insufficient national saving. Without an increase in

U.S. domestic saving, less foreign borrowing means higher U.S. interest rates and lower domestic investment. While our current practice of financing half of U.S. capital formation through foreign borrowing requires debt servicing, it nonetheless raises U.S. incomes by allowing firms to pay higher wages and taxes. Americans are better off borrowing from abroad to finance capital formation than not borrowing and having less capital formation in the United States. Moreover, a sudden large decline in the value of the dollar would create considerable adjustment problems. It would be foolish to apply a dollar strike to ourselves simply to avoid having it applied by others.

Similarly, it would be folly to try to balance the federal budget deficit in just one or two years. Such measures would plunge the economy into a recession. Instead therefore, we should aim at reducing our twin deficits roughly in tandem—avoiding the inflationary extreme of bringing the trade deficit down too rapidly and the recessionary extreme of bringing the budget deficit down too rapidly.

The preferred approach is to embark on a steady program of deficit reduction. The pace envisaged under the Gramm-Rudman targets is reasonable. As the budget deficit withdraws purchasing power from the economy, the Federal Reserve should offset this effect with lower interest rates and a weaker dollar, keeping the economy on a non-inflationary full-employment growth path.

Credible implementation of such a program would allow the U.S. to adjust its spending patterns at a pace and by means of its own choosing. While it may not be highly likely, the possibility that the foreign exchange markets will suddenly lose confidence in the U.S. cannot be completely discounted. Enacting a credible, medium-term deficit reduction program would enhance international confidence in the ability of the U.S. manage its own affairs. It would increase the national saving rate to more desirable levels and dramatically improve the ability of the Federal Reserve to sustain economic growth without inflation. Such a program would also give other countries sufficient notice to take the necessary offsetting stimulative action to sustain their growth.

Implementing such a program would also allow the U.S. to regain the use of fiscal policy for stabilization purposes, enhance U.S. world leadership and improve U.S. trade performance. In the 1982 recession, we were able to stimulate the economy by a series of major tax cuts. If a recession were to occur today, however, we would find it almost impossible to stimulate the economy with tax cuts or increased government spending. We now depend on the Federal Reserve and foreign growth to stabilize our economy in a slump. The sooner we regain control of fiscal policy, the sooner we will increase our autonomy in macroeconomic policy.

Our ability to lead in the world has been reduced, not because we are in decline but rather because of our spending patterns. A dependent America seeking cooperation from foreigners on burden-sharing is less capable of leadership. In the long run, moreover, if Americans want to sustain the world's highest living standards, they will have to match the rates at which foreigners save.

Increased U.S. saving would provide more resources for U.S. capital formation which would enhance our competitiveness. A smaller budget deficit would make room for a lower dollar to stimulate U.S. trade performance and thus improve the prospects for our trade-dependent firms in agriculture, mining and manufacturing.

Table 1. Components of U.S. National Saving

	National		Private			Government			
	Net	Gross	Total	Business	Personal	Total	Federal	State and local	State & local Pensions
1950s	7.4	16.1	16.2	11.4	4.7	-0.1	0.1	-0.2	0.4
1960s	7.9	16.3	16.6	11.9	4.6	-0.3	-0.3	0.03	0.5
1970s	7.1	16.7	17.6	12.0	5.6	-1.0	-1.7	0.8	0.8
1980s	3.1	14.2	16.7	12.9	3.8	-2.6	-3.9	1.3	1.2
1977-80	6.9	17.4	17.8	13.0	4.8	-0.4	-1.6	1.2	1.0
1981-88	2.8	13.9	16.6	13.0	3.6	-2.7	-4.1	1.3	1.3
1988[1]	2.9	13.3	14.9	12.0	2.9	-1.7	-2.8	1.2	1.4

[1] First three quarters.

Table 2. U.S. National Saving and Investment (share of GNP)

	Net domestic investment	Net national saving[1]	Net foreign borrowing[2]
1950s	7.5	7.4	-0.1
1960s	7.1	7.9	-0.6
1970s	6.9	7.1	-0.2
1980s	4.8	3.1	1.6
1977-80	7.0	6.9	0.1
1981-88[3]	4.7	2.8	2.0
1980	4.9	5.2	-0.5
1981	5.5	5.7	-0.3
1982	2.0	2.0	0.0
1983	3.1	2.0	1.0
1984	6.6	4.1	2.4
1985	5.1	2.4	2.8
1986	5.0	1.9	3.4
1987	5.1	1.8	3.5
1988	5.4	2.9	2.8

Source: National Income Accounts.

Notes: [1] Net private saving and government deficit.
[2] Negative number indicates U.S. lending.
[3] First three quarters at 1988.

Table 3. Investment as a Share of GNP

	Gross		Net	
	Nominal	1982 dollars	Nominal	1982 dollars
1950s	16.4	16.4	7.5	x
1960s	16.5	16.5	7.1	x
1970s	16.4	17.2	6.9	6.8
1980s	15.8	16.7	4.7	5.1
1977-80	17.5	17.5	7.0	6.9
1981-88	15.8	17.0	4.7	5.1
1988	15.7	18.2	5.4[1]	6.2

[1] First three quarters.

Chairman ROSTENKOWSKI. Mr. Entin.

Mr. ENTIN. Mr. Chairman, I was substituting for Dr. Ture.

Chairman ROSTENKOWSKI. OK. Dr. Ture.

Mr. ENTIN. He will read the statement. Thank you.

Chairman ROSTENKOWSKI. Fine. Dr. Ture.

STATEMENT OF NORMAN B. TURE, PH.D., PRESIDENT, INSTITUTE FOR RESEARCH ON THE ECONOMICS OF TAXATION, ACCOMPANIED BY STEPHEN J. ENTIN, RESIDENT SCHOLAR

Mr. TURE. It is a pleasure to have the opportunity to be here with you. I am sorry about the confusion about my appearance.

I appreciate having the opportunity to have Mr. Entin backstop me, if needed.

I wholeheartedly agree with my fellow panelists that it is extremely important, and ought to be a very high priority for the Congress to bring the budget deficit down, but I disagree about the reasons for doing so.

I believe the principal budget policy challenge is not to reduce the deficit in order to avoid its alleged damage to the economy, but, rather, the principal budget policy challenge is to find some device that will provide an effective economizing constraint on Federal spending and decisionmaking, to assure that Federal programs warrant the cost they impose on the economy.

This is an aspect of the budget deficit issue which has received precious little attention, and I think ought to receive primary attention, and ought to be the highest priority issue.

Deficits misinform us, as citizens and as decision-makers, about what the cost of Government is. They make us believe those costs are less than they really are, and they weaken our insistence on economizing in the public sector.

I cannot find evidence of the impairment of the economy's performance by the Federal budget deficit, nor do I believe that the budget deficit has any reasonable connection with the trade deficit.

I think the committee and the Congress should be highly mindful of the fact that we have made a great deal of progress in reducing budget deficits, and if you look at the Congressional Budget Office's, current service budget projections, they indicate that further reductions will be made without any tax increases, and without any draconian changes in spending programs.

Deficit reduction, as history shows, and as logic tells us, depends primarily on slowing spending growth. Reasonable scenarios, incidentally, show that even a severe recession, one on the order of the one that we experienced in 1981-82, with the sort of recovery therefrom that we experienced in the ensuing years, would only temporarily set back the progress in deficit reduction, with a big proviso; that policymakers continue to impose at least moderate constraints on spending growth. Tax increases, in contrast, would be economically injurious and would be far more likely—again both history and logic suggest—to be devoted to funding more spending rather than to reducing the deficit.

I think that repeated suggestions to exclude Social Security flows from budgetary calculations and from Gramm-Rudman-Hollings deficit targets would do nothing to improve the position of Social Security beneficiaries, either now, or in the foreseeable future.

If such exclusions led to higher taxes—and I believe that is the reason for the proposal—the adverse economic effects would impair rather than improve the economy's capacity to service Social Security obligations.

Setting Social Security apart from the rest of the budget, moreover, would misinform policymakers, and all of us, about the real impact of the Government's fiscal operations.

To repeat, any tax increase, I believe, would have an injurious effect on the economy's efficiency and growth. Even if used to reduce the budget deficit—which I regard as highly improbable, again on the basis of the record—tax increases would not increase national saving. Private saving would fall. The best that one could hope for is that private saving would fall in no greater proportion than private consumption outlays.

The current account deficit, it should be recalled, equals the gap between national saving and investment. A tax increase would not close that gap except by reducing investment, growth and productivity gains. And that, of course, is exactly contrary to the stated purpose of deficit reduction. The only pro-growth means of reducing the budget deficit and the trade deficit simultaneously is to cut Government purchases of goods and services. The twin deficit concept is a myth with many counterexamples available in the experience around the world.

I believe that, to improve budget policy, tax restructuring, not tax increases, is called for.

The tax system should, far more effectively than it presently does, price out Government activity. This calls for closely tying spending increases to anticipated revenue increases, and for insuring that as many citizens as possible recognize that each of them must assume his or her share of the tax burden.

Those conditions are not met by most of the taxes and tax provisions in the present tax system.

Let me offer, if I may be so bold, a number of specific budget process changes that I believe would move toward establishing more effective economizing constraints on budget decisionmaking.

These include, first restatement of Gramm-Rudman-Hollings' targets in real rather than nominal terms. Second, the Congressional budget procedure should be revised to require the Congress to set revenue targets for the fiscal year before taking up spending authorizations, with limitations of outlay increases to the projected increases in revenues.

I believe that if this committee and the committee in the Senate with the same responsibilities were given the obligation, first, to set revenue targets, and those revenue targets represented at least the initial constraints on the spending decisionmaking of the Budget Committees, that we would move toward at least a rough simulation of the kind of budget decisionmaking that must be made in every household and every business in this country.

Third, I believe that all spending programs should be required to be on budget. Off-budget accounting misinforms, and leads to, it seems to me, erroneous and improper decisions about the kinds of things Government ought to get engaged in.

Fourth, we need a revision of the budget accounting system to conform it, as closely as possible, with generally accepted accounting principles. The existing budget accounting system is a hodgepodge, an olio of mixed concepts; we confuse balance sheet and income-and-expense statement items; we treat sales of assets as if these were income flows. We make no provision for the future obligations that today's spending decisions entail.

We are essentially on a very confused kind of cash basis. It seems to me we would do very well indeed, by way of informing ourselves of budget implications, if we were to go onto an accrual basis with the sort of concepts that guide accounting in the private sector.

Fifth, I think we need to measure changes in budget outlays and revenues through time, that is, year over year, by reference to the preceding year's actual outlays, authorizations and receipts. We should use current service budget quantities only to show, and measure the effect of a proposed change in authorizations or provisions in the law in the target fiscal year, or years.

Finally, I would grant the possibility that as time goes on tax increases will be enacted, much as I would regret that development. If those tax increases really are to be devoted to reducing the budget deficit, it seems to me some steps need to be taken to insure that result.

I would suggest that rather than allow any such tax increase to be used to fund additional spending, those tax increase revenues should be impounded by requiring an equal increase in the Treasury's cash balances. Moreover, the debt limit should be raised only by the amount of the previously projected deficit target, less the tax increase, so that added borrowing cannot cover increases in spending.

Thank you very much, Mr. Chairman.

[The statement of Mr. Ture follows:]

THE BUDGET DEFICIT, THE U.S. ECONOMY, AND FEDERAL BUDGET POLICY

Statement by
Norman B. Ture, President
and
Stephen J. Entin, Resident Scholar
Institute for Research on the Economics of Taxation
to the
Committee on Ways and Means
February 8, 1989

Mr. Chairman, members of the Committee, I am pleased to have the opportunity to appear today to discuss with you the budget and tax policy issues confronting the Congress and the Nation. The views I express in this statement are my own and are not necessarily those of the Institute for Research on the Economics of Taxation, its board of directors, staff, or contributors.

Introduction: An Overview

As the Committee and the Congress, with the constructive cooperation of the Administration, begin efforts to frame the federal budget for fiscal 1990, they would do well to identify the challenges and issues to be faced in this undertaking. These far transcend mere questions of how much and in what specific ways to reduce the federal budget deficit in the coming fiscal year. Concern about the deficit has dominated fiscal, tax, and budget policies for many years past, too often to the neglect of other matters at least as urgent as deficit reduction. This Committee and others in the Congress have been at that work for several years now, and although substantial progress has been made, it clearly has not been adequate to eliminate deficit reduction as one of the most demanding items on the policy agenda. As I shall point out later in this discussion, the failure to accomplish greater reduction of the deficit is attributable in large part to the failure of both the Congress and the Administration to deal with the fundamental problems of budget policy.

I respectfully but strongly urge this Committee to begin its efforts by determining what are the major budget policy concerns it should address. Reducing the budget deficit to zero in some target year should not be seen as the principal budget policy challenge this Congress and the Administration face. Far more urgent is the need to identify and address much more fundamental issues of budget policy. In particular, it is essential to establish some more effective economizing constraints in budget policy making to assure that the uses to which the federal government's spending programs put the nation's production resources warrant the costs thereby imposed on us.

I do not mean to suggest that budget deficits should be of no concern to our public policy makers. At present, however, that concern is not well focused. It must be clear to all but those who refuse to see the world around them that the economic mischief commonly attributed to budget deficits hasn't materialized. The performance of the economy since late 1982 has exploded the unfounded notions that budget deficits generate inflation, raise interest rates, crowd out capital formation, and in other, generally unspecified ways undermine the economy and make it "fragile," whatever that term is supposed to mean when applied to so huge, so dynamic, and so complex an economy as that of the United States. If the growth record of the U.S. economy of the last several years and its current performance do not reflect economic strength, one will be very hard put to find a time when this economy has ever been strong.

The appropriate concern about budget deficits is much subtler but, I believe, much more urgent. That concern focuses on whether public policy decisions about what and how much government does reflect the informed willingness of the people to assume the costs of those activities. Deficits mask those costs; even worse, deficits mislead us about them. As a body politic, we can't effectively communicate our preferences to our elected public policy makers about what we want government to do if we are not acutely aware of what it will cost us to have government do it. Deficits let us believe that the cost is less than it really is. The disinformation effect of budget deficits makes us less intent on constraining our policy makers' proclivities to overspend.

We need to make further progress in reducing the deficit for this very reason. Since fiscal 1986 substantial progress has been made in reducing budget deficits, primarily as a result of the deceleration of the growth of federal spending. Realistic projections of federal budget trends and outcomes urge that progress is likely to continue, that continuing substantial reductions in the deficit can be achieved, with no tax increases, provided that our budget policy makers impose moderate restraints on the growth in total federal outlays. If Congress deems the prospects for constraining the expansion of federal spending to be so poor that a tax increase is needed to reduce the deficit, then it should recognize that the economy's performance and growth will be impaired both by the expansion of the federal government's spending and by the additional taxes that would be raised to finance these additional outlays. If spending growth cannot be effectively limited, it is extremely unlikely that tax increases will, in fact, be applied to reducing the budget deficit; it is far more likely that additional tax revenues will be used to finance additional federal outlays.

There is virtually no tax increase that will not adversely affect private saving and capital formation, economic efficiency, and growth. No significant increase in national saving will result from a tax increase. No tax increase will reduce "crowding out." And realistically perceived, no tax increase will be restricted to deficit reduction. The reason to raise taxes, after all, is to finance more government spending, not less.

If, notwithstanding their adverse economic effects, taxes are to be increased, any such increase should satisfy a number of essential criteria. Merely raising taxes will not serve very long to reduce the budget deficit. If budget deficits are to be reduced to acceptable levels and kept there, significant changes in the kinds of taxes we rely on to finance the federal government, not tax increases, will be needed. The federal tax system needs to be made far more effective than it now is in performing the basic function of a tax system -- to price out the government's activities. None of the tax increases that have been widely proposed would contribute to achieving this objective. Whether any of them would reduce the deficit in the short run is questionable; virtually all of them would surely contribute to faster expansion of the federal government in the long run.

The Budget Outlook in Real Terms

It is vitally important that the Congress look at where the deficit is headed, not merely where it is today nor where it has been. It is equally urgent that the Congress look at the deficit in real terms, corrected for the distorting effects of inflation. The economically relevant real deficit is headed for virtual extinction under current law by 1993.

Looking Ahead

The projections of current services outlays and revenues in the fiscal 1990 budget projections of the Office of Management and Budget and in the Congressional Budget Office's January 1989 **Economic and Budget Outlook** strongly urge that substantial progress in deficit reduction will continue. CBO projects the deficit slowly falling to $122 billion, 1.7 percent of GNP, in fiscal year 1994; OMB predicts a far steeper decline in the deficit to $8.7 billion in that year. In both cases, the national debt, measured in current dollars, would be growing more slowly than the economy, leading to a lower debt service burden on the budget over time. Neither set of projections includes any tax increases other than those specified in existing statutes; both include the increase in payroll taxes scheduled to occur in 1990. These projections are summarized in Tables 1 and 2.

Of particular interest is that both OMB and CBO project current services outlays growing over the projection periods at average annual rates well below 6 percent, 4.1 percent in the OMB projection and 5.7 percent in the CBO estimates.[1] These average expansion rates compare with 13.5 percent in the fiscal years 1973 through 1981 and 6.7 percent in the fiscal years 1982 through 1988. The lower rates projected for fiscal years 1989 and beyond are a testimonial to the efforts of the Administration and the Congress to curb the expansion of federal government activities. The fact that spending growth has been so sharply slowed demonstrates that, contrary to the conventional wisdom, changes in federal spending programs to reduce their size and growth are quite feasible.

Examination of the major components of total federal outlays provides the basis for confidence that substantial continued progress in reducing the deficit without tax increases is not only feasible but likely. Net interest payments now represent over 90 percent of the deficit (net interest is the interest paid by the government less the taxes paid on the interest by those who receive it). Because net interest accounts for almost the entire deficit, almost all of the increase in the federal debt is accounted for by the amount of net interest.

The cyclical element of the deficit, the part that reflects the automatic increases in outlays and the loss of revenues due to the 1981-82 recession, is nearly zero. Measured on a national income and product accounts basis, the non-interest structural (programmatic) portion of the Federal budget will swing into surplus in fiscal 1990. That is, outlays on Federal programs other than interest will fall below revenues other than taxes on federal interest payments. At that point, the non-interest surpluses in the Federal budget will be subtracting from, rather than adding to, the deficit and the federal debt, reinforcing the tendency for the economy to outstrip the growth of debt due to net interest payments. The combined effect of these projected developments is that the deficit will continue to fall as a share of the GNP over time.

The Real Budget Outlook

Measured in constant dollars, rather than, as above, in current dollars, the deficit-reduction prospects, as projected by both OMB and CBO, are even brighter. Everyone has had enough experience with inflation to recognize the need for measuring economic and financial quantities in real terms, not merely in current dollars. Without adjusting for inflation, we get a distorted impression of economic magnitudes.

Everyone is familiar by now with the difference between nominal and real interest rates and with the effects of a change in the rate of inflation on the real value of outstanding debt and the interest paid on that debt. Regrettably, no adjustment to take account of inflation is made in measuring federal budget magnitudes or results. In assessing the magnitude of the deficit problem, however, it is essential to distinguish between the real and nominal deficit and the real and nominal debt.[2]

The nominal deficit in any year -- the excess of outlays over receipts -- is, by definition, also equal to the change in the nominal debt from the prior year. The real deficit, by the same token, is the change in the real value of the debt from one year to the next. The real value of the debt equals the real purchasing power that debt represents. If prices are rising, the increase in the debt measured in current dollars will overstate the rise in the real debt and overstate the real deficit. To put the reported, nominal deficit in real terms, one must adjust it for the effect of inflation on the outstanding nominal debt. This adjustment means subtracting from the nominal deficit an amount equal to the effect of inflation on the real value of the outstanding debt.

Suppose, for example, that at the beginning of a year the federal debt is, say, $2,500 billion and that during the course of the year budget outlays exceed budget receipts by $100 billion, measured in current prices. Suppose, moreover, budget receipts are just equal to program outlays, so that the $100 billion deficit just equals nominal interest, at 4 percent, on the debt. At the end of the year, the nominal debt is $2,600 billion. Suppose, however, that the overall level of prices at the end of the year is 2 percent above the level at the beginning of the year, such that each dollar only buys 98 percent as much as the year before. In this case, the real value of the debt at the end of the year, measured in terms of unchanged purchasing power, is $2,548 billion ($2,600x0.98 = $2,548). In real terms, the deficit is $48 billion. By the same token, the owners of the debt received $48 billion in interest in dollars of constant purchasing power, not $100 billion. From the $100 billion in nominal interest they must deduct the $52 billion decrease, due to inflation, in the real value of the debt they own.

With the current inflation rate of about 4 percent per year, the real value of that portion of the national debt held by the public (about $2,050 billion in fiscal 1988) may be expected to fall by about $90 billion in fiscal 1989 and by close to $120 billion in fiscal 1994, based on CBO baseline projections. This amount must be subtracted from the nominal year-over-year change in the national debt to find the real deficit for the year.

Making these adjustments, the real federal budget deficits, based on CBO baseline projections, decline from $91 billion in fiscal 1988 to $5 billion in fiscal 1994. These adjustments are shown in Table 3.

In dealing with deficit-reduction targets, the Congress should focus on real rather than nominal deficits. As long as inflation continues at rates significantly above zero, the goal should not be a zero deficit in current dollars, unless surpluses in real terms are deemed to be essential to achieve some meaningful policy objective.

Impact of Recession

The deficit reductions projected by both OMB and CBO are widely challenged on the grounds that the continuing, although slower, economic growth over the projection period assumed by both organizations is unlikely, in view of the extraordinary length of the current expansion. Many have expressed concern that the optimistic current services forecasts could be derailed by a recession between now and 1994. A recession, it is frequently maintained, would reduce current services revenues quite substantially while increasing current services outlays, thereby expanding the deficit and setting back efforts to reduce, if not eliminate it.

In fact, however, quite plausible economic and budget scenarios strongly suggest that very substantial reductions in the deficit are attainable without tax increases, even in the face of a severe recession in the near future. While a recession would temporarily boost the deficit, it would not have a lasting impact.

In testimony to the National Economic Commission in September 1988, I presented several such scenarios. I'll be happy to submit for the record the portions of that testimony laying out those scenarios and their results, if the Committee wishes.

The central finding of the alternative scenarios is that the really effective key to deficit reduction is to moderate the growth in federal outlays. No drastic curtailment of overall spending is needed to achieve substantial deficit reduction, following the deficit surge that would result from the supposed recession. Even with spending growth rates noticeably more rapid than those in the CBO baseline projections, budget deficits fall in both absolute amount and as a fraction of GNP, with no tax increases other than those scheduled under present law.

If budget policy makers were to impose truly rigorous constraints on the expansion of federal outlays, the reduction in the federal budget deficit, indeed its total elimination, could be accomplished in very short order, without tax increases and even in the face of a severe recession in the near term. Indeed, mindful of the admonition of focusing on real rather than nominal budget results, significant tax reductions would be possible without resulting in a real deficit. For example, if spending growth were prevented from exceeding the inflation rate, the nominal budget would move substantially into surplus in fiscal 1994. As before, no tax increases are assumed, and the pattern of recovery and of economic growth following the recession closely conform with actual experience following the 1981-1982 recession.

The zero growth in real total outlays implied by constraining expansion of nominal spending to the inflation rate would assuredly require the exercise of a kind of budgetary discipline seldom seen in the United States in modern times. Unless entitlement programs were modified to reduce substantially the level of their growth path or their rate of growth, very significant reductions in the absolute amounts of other programs, not just cutbacks from their projected current services levels, would have to be made.

In itself, this drastic pruning of the enormous array of federal spending programs is neither implausible nor undesirable; it strains credulity to assert that every federal spending program and program element could be justified, relying on even the most genial cost-benefit test. There are enormous savings to be made by eliminating or reducing federal activities and programs that produce returns far less than the costs they impose on the nation. The problem in realizing these savings is the formidable difficulty even the most eager outlay-cutter would encounter in identifying these programs and in determining the extent to which they could and should be cut. One of the major sources of this difficulty is the effort by those in and out of government who have a stake in these activities and programs to protect them from cuts, indeed to expand them. Another source of difficulty is the lack of meaningful concepts of both benefits and costs of these programs and activities.

These difficulties have, of course, long been noted. Although no easy resolution of them has yet been discovered to be workable, this is certainly not to say that the task is hopeless. Many business and household decision makers often find it extremely difficult to exercise constraint on their spending, yet for the most part they find means for confining their outlays to amounts that their present and future resources can finance. Public decision makers should be able to do so, as well.

Restraining the growth of federal spending is desirable in itself, irrespective of whether net budgetary outcomes are deficits, surpluses, or tidy balances. When the perceived need to reduce the budget deficit confronts budget makers with the choice of spending restraint or tax increases or some combination of the two, the urgency in restraining spending growth is all the greater. Any tax increase will be injurious to the economy; a great many spending reductions will be economically beneficial. Disciplining federal spending decisions should be the highest priority objective of the Congress in addressing the federal budget deficit.

Accounting for Social Security

The Gramm-Rudman-Hollings deficit targets and the budget projections of the CBO and OMB are often criticized because they address the total budget, including the off-budget Social Security accounts (Old Age and Survivors Insurance and Disability Insurance, jointly referred to as OASDI). The usual argument is that by failing to isolate OASDI from the rest of the budget, the surpluses that are realized by the Social Security System are being used to finance other government activities rather than being saved to fund future retirees' annuities and other System benefits. It is indeed true that the excess of the current payroll tax receipts over System payments is used to finance other government programs; it is not true, however, that if this were not the case, these excess funds would be available to pay future benefits.

As the Committee knows, excess OASDI funds must, by law, be invested in federal government debt instruments issued for this purpose. This transaction involves crediting the trust fund with the federal bonds and adding the excess funds to the Treasury's cash balance. If these funds could not be used to pay for other expenses of the government, their impoundment in the Treasury's cash balance would reduce the nation's money stock, dollar for dollar. It would not add to the nation's total production resources. No additional capital, in any real sense, would be created to produce additional income that could be paid to OASDI beneficiaries.

Moreover, setting OASDI system flows apart from the rest of the budget would misinform budget policy makers and all of us about the real impact of the government's fiscal operations. These operations may be described on the spending side as the purchase of goods and services and transfer payments and on the receipts side primarily as taxes. The most significant way of analyzing the effects of these fiscal actions is in terms of their effects on relative costs and prices; accurately measuring the aggregate amount of these flows is also extremely important for evaluating the extent to which the nation's production and the income claims therein are directed or claimed by the government. Dropping OASDI flows out the budget reckoning would mislead and misinform the budget policy making-process.

The accident of a surplus in the OASDI accounts and a deficit in the rest of the budget is simply being used to argue for a tax increase to support additional spending. The apparent objective is to raise taxes to avoid deeper cuts in discretionary spending, that is, to spend more than GRH would otherwise permit, and to shelter Social Security from contributing to deficit reduction. This can be seen most clearly by considering the following question. If the total deficit were as currently projected, but OASDI were showing a rough balance into the future, while the on-budget accounts were showing a correspondingly lower deficit, would there be a cry to run a total budget surplus? It is highly unlikely.

The Economic Effects of Tax Increases

Any proposal for raising taxes to reduce the deficit confronts the need for promoting saving, investment, and economic growth. The argument on which such proposals are based is that properly designed tax increases will reduce consumption uses of private sector income and, by reducing the budget deficit, increase national saving, hence capital formation and economic growth. The argument mistakenly assumes that private saving is unaffected by a tax increase. In fact, virtually any feasible tax increase will reduce private saving far more severely than consumption, at least in the near term. Moreover, virtually all feasible tax increases will impair market efficiency by inducing less efficient use of our production capability than would otherwise be realized.

Every tax ever devised alters relative costs and prices and therefore induces households and businesses to use their income and the production capability at their disposal in ways that differ from the uses they would make of them in the absence of the taxes. Minimizing these distortions has long been recognized as the central economic objective of a constructive tax policy. Obviously, the lower the real marginal rate at which any tax is imposed, the less will be its distorting effects; by the same token, tax increases must accentuate distortions and additionally impair economic efficiency.

In the present federal tax structure, inherent, basic features of the income taxes impose a severe tax bias against saving and in favor of current consumption; the individual income tax also raises the cost of using one's time, skills, and resources in ways that produce taxable income streams compared to ways that produce nontaxed income. Payroll taxes have the same adverse effect in raising the cost of providing labor services compared with so-called "leisure." Excise taxes directly and explicitly raise the costs of production and/or prices of the taxed products, services, or activities relative to others. Unless one assumes that people are utterly unresponsive or perversely and irrationally responsive to these changes in relative costs and prices, the consequence necessarily is distortion of production and less saving and capital formation than would otherwise occur. The higher is the amount of any one or all of these various taxes, the more severe are the distortions imposed on the economy's performance. Tax increases are injurious and should be assiduously avoided unless some more-than-offsetting gains can be identified.

As indicated, the offsetting gain that presumably is sought by raising taxes is an increase in national saving. If a tax increase is to achieve this result, it must somehow reduce private saving in an amount less than the increase in taxes (assuming, of course, that the additional tax revenues are dedicated to reducing the deficit rather than to financing additional government outlays). Neither economic analysis nor history support the contention that tax increases come out of consumption rather than saving.

The largest component by far of gross national saving is gross business saving, consisting of retained corporate earnings and business capital consumption allowances. The direct, immediate effect of any increase in business taxes is to reduce business saving dollar for dollar with the tax increase. In addition, any such tax increase raises the cost of capital, hence the cost of saving, and induces a reduction in the share of income that people commit to saving as opposed to current consumption. No increase in national saving can be achieved through any increase in business taxes. On the contrary, national saving will, in all likelihood, be reduced by increases in business taxes.

Much the same results are to be expected from increases in individual income taxes. Virtually all such increases will accentuate the income tax bias against saving and induce a decrease in the proportion of income that would otherwise be saved, other things equal. Increases in real marginal income tax rates, irrespective of the way in which they are effected, also adversely affect the supply of labor services, resulting in higher unit labor costs and lower employment levels than would otherwise prevail. These tax increases raise the cost of increasing one's income-producing capacity and, therefore, lower the pace of productivity advance.

Increases in selective excises induce purchasers of the taxed products to change the composition of their consumption outlays, not necessarily to reduce the aggregate amount of consumption. They also result in cutbacks in output of the products subject to the higher tax rates, resulting in cuts in employment and labor income in the industries producing the products. Part of the additional excise tax revenue also is extracted from the payments for capital services committed to the taxed production. This raises the cost of capital in those industries and, in time, leads to higher capital costs in all parts of the economy, with a consequent reduction in saving and capital formation, along with changes in the composition of the stock of capital and its industry allocation.

A broadly-based, uniformly applied value added tax of the consumption variety would not raise the cost of saving relative to the cost of consumption, but it would increase the cost of both in equal proportion. Whether one perceives the burden of the tax as resting on consumers or on those generating the value added, i.e., suppliers of labor and capital services, it should be obvious that the imposition of a VAT as an additional tax cannot increase private saving but must reduce it.

There is a substantial and growing economics literature attesting to the adverse effects of taxation on economic efficiency and on an economy's growth. There is also a substantial literature that shows that raising taxes has little if any positive effect on national saving. For example, a recent study, "The Impact of Government Deficits on Personal and National Saving Rates," by Darby, Gillingham, and Greenlees of the Office of Economic Policy, U.S. Treasury Department, found that, at least in the first several years, a rise in taxes and government saving is largely offset by a decline in private saving. By contrast, a cut in government spending primarily reduces national consumption and raises the national saving rate. A few years ago, I wrote two short essays that reach the same conclusions.[3]

These conclusions about the adverse effects of taxation on saving, based on economic analysis, are supported by common sense observations and a look at the historical record. Consider the effect of an increase in individual income taxes. In the typical case, a substantial fraction of a household's expenditures are highly inflexible, at least in the short run. One cannot quickly reduce rent or mortgage payments or the service costs of other consumer indebtedness. It is, similarly, difficult quickly to alter patterns and levels of discretionary outlays, even those for which the household has no fixed commitments. The additional taxes reduce household saving dollar for dollar, at least until the necessary adjustments in consumption can be made. Even (mistakenly) ignoring the effects of individual tax increases in raising the cost of saving relative to consumption, therefore, the widespread institutional arrangements in the economy argue that individual tax increases erode saving to a far greater extent than consumption.

The historical evidence confirms that raising taxes reduces saving and by more than the tax increase. The income tax surcharge enacted in 1968 is a case in point. As a fraction of GNP, consumption went up during the surcharge years, while gross private saving went down in relation to GNP. Had the saving rates in 1968-1970 remained at the same level as in 1967, gross private saving would have aggregated $47.6 billion more than the actual saving in those years. The loss in private saving was more than twice the roughly $23 billion in additional tax revenues produced by the income tax surcharge. The tax increase did not increase national saving; it reduced it. It didn't reduce "crowding out;" it increased it.

Because of the adverse effect on private saving, tax increases will not raise national saving or reduce crowding out. Real crowding out is the absorption of real resources by the government. No matter how it is financed, a government purchase of manpower, steel, concrete, or computers deprives the private sector of these resources and products. Government purchases of goods and services not only directly reduce the resources available to the private sector, they also distort relative prices and costs. Government transfer payments almost invariably entail unintended and undesirable effects on the relative costs confronting the transfer recipients; they very often discourage work effort and saving, hence capital formation and productivity advance. Limiting these distortionary effects and preemption of resources available to the private sector is the compelling reason for imposing the greatest possible constraint on the expansion of federal outlays while avoiding tax increases in efforts to reduce federal budget deficits.

Attributes of a Tax that Prices Out Government Activities

If it were decided that tax increases are needed to reduce the deficit, notwithstanding the progress in deficit reduction that is likely in the absence of tax increases and the economic damage tax increases would do, the question confronting the Congress would be what tax increases should be recommended. For the long run, more pressing than reducing the deficit is the need to introduce an effective discipline on government spending decisions in budget policy making. Federal finances will not long stay out of the red in the absence of something that confronts budget policy makers with the cost of increasing federal outlays.

In a very real sense, the most effective constraint on budget policy makers' spending decisions is the average citizen's perception of the out-of-pocket cost each such decision imposes on him. The effectiveness of this constraint clearly depends on establishing a close relationship, at least at the margin, between spending and taxing. Just as importantly, it depends on ensuring that the largest possible number of the citizenry recognize that each of them must assume his or her share of any such additional tax burden imposed by additional spending. The basic need for enduring and significant budget policy reform is to move to reliance on a tax system that effectively prices out the activities of the federal government.

The attributes of a tax system that can effectively perform that function are simply summarized:

o Taxes must be imposed only on individuals. Corporations and other legal but not real persons do not pay taxes; only real, living human beings can pay taxes, whether in their capacity as sellers of productive services or buyers of products and services. Taxes levied on corporations tend to escape perception by the individuals who will ultimately bear their burden.

o Taxes should be imposed on the broadest possible income base, correctly measured, allowing deductions only for the costs incurred by the individual in producing taxable income. In the interests of making the tax as nearly neutral as possible in its impact on the choice between current consumption and saving, there should be the broadest and most general possible exclusion from the tax base of current saving and the most complete possible inclusion in the tax base of all returns on saving.

o Taxes should be imposed at the lowest and flattest possible statutory rates, relying on a zero-rate bracket to afford whatever degree of progression in effective tax rates is deemed to be required. Marginal rate graduation is the equivalent of a system of increasing selective excises on income-producing, productivity-advancing activity. It is difficult to identify any meaningful objective of public policy that is served by this graduation.

o Taxes with the attributes just specified should be imposed on the largest possible number of people and in such a manner as to make each of them as aware as possible of his or her tax liability. The pricing out function cannot be adequately performed if large numbers of individuals are excused from assuming tax liabilities or if they are unaware of the taxes they bear. Tax "simplification" achieved by removing millions of individuals from the tax rolls is directly at odds with achieving a tax system that will ensure the voting population's awareness of the burden that public spending imposes on them.

Virtually none of the proposed tax increases that have been widely publicized can meet the test of effectively serving to price out government activities, hence to constrain their growth. Proposals to increase corporate income tax liabilities, whether by rate increases, increases in alternative minimum taxes, limitations on capital recovery allowances, or whatever, fail the test of adequately engaging the awareness of the individuals -- all of us -- who would ultimately bear the burden of these additional taxes. Such tax increases also raise the cost of capital and depress saving and capital formation compared to levels that would otherwise be achieved.

Raising the income tax rate, or adding a higher tax rate, for upper-income individuals imposes the responsibility for defraying a larger part of the cost of government on a relative handful of the population. Apart from the adverse effects of any such tax increase on saving and investment and on the productive, market-directed efforts of those bearing the additional taxes, this tax increase obviously would not inform the great mass of the population of the cost of government. Moreover, if deficit reduction is correctly seen as benefitting the economy as a whole, everyone should be called upon to contribute to that deficit reduction. Uncapping the wage and salary base for payroll tax purposes suffers the same serious deficiency and increases the relative cost of using some of the most productive labor and human capital resources in the country.

The same objections apply with respect to proposals to raise selective excises. Enhancing the distortionary impact of such taxes is bad public policy under the best of circumstances. Raising these taxes in order to reduce the budget deficit, presumably to the benefit of all of the economy's participants, in effect calls upon the producers and purchasers of the taxed products to pick up the check for all of us.

There is much to be said on the grounds of tax neutrality and economic efficiency for substituting a value added tax for the income, payroll, and excise taxes in the present tax system. A value added tax, however, no matter the form in which it is levied nor the collection method it relies on, is not likely to meet the test of public awareness. As an additional tax, it suffers not only that disability but its adverse effects on the costs of saving, capital, and labor services, as well.

A tax that would reasonably satisfy the criteria spelled out above is a consumption-based income tax. The basic features of this tax have been spelled out in a number of books. Particularly useful are the expositions in **Blueprints for Basic Tax Reform**, by David Bradford and the U.S. Treasury Department's Tax

Policy staff, first published in early 1977, and **Consumption Taxes: Promises and Problems**, by Michael Schuyler of the Institute for Research on the Economics of Taxation. Moving to a tax of this kind as the mainstay of the federal revenue structure would pose difficult problems of transition, and post-transition compliance and enforcement difficulties. Its advantages with respect to the pricing out of government activities, however, warrant its receiving the very serious consideration of the Congress.

Budget Process Changes

I recognize that undertaking a major restructuring of the federal tax system is not likely to be on the Congress's agenda in the very near term, however useful such a restructuring might prove to be in dealing with the basic budget policy issues. Let me offer a number of recommendations for budget policy and process changes of much less heroic proportions.

First, restate Gramm-Rudman-Hollings budget deficit targets in real rather than nominal terms, as discussed above.

Second, revise the Congressional budget process to require the Congress to set revenue targets for the fiscal year(s) for which the budget is to be adopted before taking up spending and outlay authorizations. Limit outlay increases to projected increases in revenues as targeted. The economizing process in households and businesses begins with projections of the resources that will be available; given such projections, one must set one's spending priorities, subject to the constraint that the total doesn't exceed one's resources. Congress could simulate this economizing in its budget making if it were to set revenue targets as limits on total outlays, before turning to spending authorizations.

Third, to improve the informational value of the budget and to improve decision making, all programs and outlays should be included on budget. It is essential to good budgeting to know the aggregate amount of the claims on resources, output, and income to be exerted and allocated by the government. Off-budget items are as relevant for budgeting purposes on this score as those now on budget. No government activity should be accounted for off budget.

Fourth, the budget accounting system should be revised to make it conform as closely as possible with generally accepted accounting principles. The present budget accounting system confuses balance sheet with income and expense statement accounts and transactions; it overlooks major categories of costs that the federal government's activities entail; it doesn't distinguish between investments and current expenses; and because it is essentially on a cash basis rather than an accrual basis, it fails to measure the liabilities that current actions create.

Fifth, insofar as budget decisions depend on measuring an outlay or receipt change through time, the Congress should use the preceding year's actual outlays, authorizations, and receipts as bench marks. Referring to current services or baseline amounts for the budget year to measure temporal changes as often as not transforms an actual year-over-year increase into an apparent reduction. This is purely and simply disinformation. Current service or baseline projections should be used as a measure of the effect in any given year of a proposed change in an authorization or provision of the law, as in "If we change the program authorization in the proposed way, outlays under the program will be such and so instead of the amount they would be under current provisions."

Finally, if a tax increase is deemed to be necessary, steps should be taken to insure that the additional taxes are used for deficit reduction, not to finance additional outlays. To implement this requirement, all additional revenues estimated to be provided by the tax increase should be impounded by requiring an increase in the Treasury's cash balance; in addition, the debt limit should be raised only by the amount of the projected deficit, taking the tax increase into account, so that added borrowing cannot cover increases in spending. Furthermore, no new off-budget financing or shifting of outlays off budget should be allowed.

None of these measures nor all of them together would solve the basic budget policy problem, but I believe that each of them would afford some improvement in the budget-making process.

The Balance of Payments

Much has been made of the supposed link between the budget deficit and the trade deficit. This is a serious misunderstanding based on a simplistic accounting identity in the national accounts. It is in no way reflective of real world behavior.

The current account (balance of payments) deficit equals the gap between national saving (private saving plus government saving) and national investment. Some have claimed that any steps taken to reduce the budget deficit will increase national saving and reduce the trade deficit. (See the top line of chart 1, labeled "myth".) This argument makes a long series of errors or unsubstantiated assumptions.

First, the budget deficit in this equation does not include transfer payments, just government purchases of goods and services. Second, it matters very much whether spending is cut or taxes are raised. If government takes less of the country's real labor, capital, goods and services, there is more for export or for replacing imports, and more real resources for producing plant, equipment and structures. A tax increase does nothing to reduce government's use of resources, quite the contrary. Third, tax increases reduce private saving, leaving national saving unchanged, and discourage investment directly by reducing its after tax return. Advocates of the "twin deficit" myth assume, incorrectly, that private saving and investment are insensitive to tax changes. (See Chart 1, lines labeled "reality".)

Even if a tax increase were to improve national saving, contrary to historical experience, it cannot, as its advocates claim, simultaneously improve national saving and investment dollar for dollar, and improve the trade deficit dollar for dollar. In fact the most likely outcome of a tax increase is to raise government spending and cut national saving by weakening the economy. Investment is sure to fall. The only way a tax increase could improve the trade balance is to reduce investment by more than saving, accentuating the adverse consequences for growth and productivity, contrary to the announced goal of deficit reduction. A government spending cut is the only way to improve the trade balance and the rate of investment at the same time.

Around the world, one may find examples of major nations with budget surpluses and trade deficits, trade surpluses and budget deficits, and deficits of both types. It is clearly the case that the simplistic juxtaposition of the U.S. trade and budget deficits proves nothing.

Conclusions

There are now numerous and persuasive indications that the federal budget deficit is on a steady downward course, particularly in relation to GNP, and that it will continue to decrease, without new taxes, even if a recession were to overtake the economy in the near term. It is fair to conclude, therefore,

Table 1. GNP and Budget Projections, CBO Baseline, Fiscal Years 1988-1994

Billions of Dollars

Year	GNP	Revenues	Outlays	Deficit
1988	4,780	909	1,064	155
1989	5,122	983	1,138	155
1990	5,454	1,069	1,209	141
1991	5,812	1,140	1,280	140
1992	6,184	1,209	1,344	135
1993	6,581	1,280	1,410	129
1994	7,006	1,359	1,480	122

Percent of GNP

Year	GNP	Revenues	Outlays	Deficit
1988	100.0	19.0	22.3	3.2
1989	100.0	19.2	22.2	3.0
1990	100.0	19.6	22.2	2.6
1991	100.0	19.6	22.0	2.4
1992	100.0	19.5	21.7	2.2
1993	100.0	19.5	21.4	2.0
1994	100.0	19.4	21.1	1.7

Growth Rates

Year	GNP	Revenues	Outlays	Deficit
1988	7.7	6.4	6.0	3.3
1989	7.2	8.1	7.0	0.0
1990	6.5	8.7	6.2	-9.0
1991	6.6	6.6	5.9	-0.7
1992	6.4	6.1	5.0	-3.6
1993	6.4	5.9	4.9	-4.4
1994	6.5	6.2	5.0	-5.4
1988-1994 average	6.5	6.9	5.7	-2.8

Source: Congressional Budget Office, *The Economic and Budget Outlook: Fiscal Years 1990-1994*, January 24, 1989. Details may not add due to rounding.

that no tax increase is required to reduce the deficit to an acceptable level; this is certainly the case if we focus on the real --inflation-adjusted -- deficit, as we should. The appropriate fiscal-budgetary prescription, insofar as the policy focus is on deficit reduction, is "steady as we go."

As Congress considers the budget issue, it should bear in mind that proposals to raise taxes, no matter the nature of the tax increase, would be in direct conflict with numerous public policy objectives that it -- the Congress -- has formulated and endorsed. Foremost among these is that public policies should contribute to, not impede, the economy's economic progress, advance in efficiency, and increase in productivity and living standards. As a corollary, public policies should contribute to, not impede, American businesses' more effective participation in the ever-increasingly integrated world economy.

Tax increases of any sort will impair the economy's efficiency by further distorting the market's price signals, hence the allocation of production resources and the uses of our incomes. Virtually any feasible tax increases will raise the cost of saving, irrespective of whether it also increases the cost of consumption. Virtually all feasible tax increases will increase the cost of labor as well as of capital services. Tax increases, no matter their form, should not be counted on to increase national saving by reducing the deficit more than they reduce private saving; to the extent that they do, we should question the desirability of socializing the saving function in our economy.

The real key to deficit reduction is limiting the rate of growth of federal spending and the expansion of federal government activities. If spending growth can continue to be constrained, as the current budget projections show, tax increases will not be needed to bring deficits down very substantially. In real terms, indeed, the budget deficit would turn into budget surpluses in the relatively near future.

If spending growth cannot be or will not be constrained by our budget policy makers, tax increases should not be counted on to reduce the deficit. The unwillingness to limit spending growth urges that any additional tax revenues will be committed to financing more spending instead of to reducing the deficit.

The Congress's top priority task should be to adopt means for subjecting federal government spending decisions to rigorous and meaningful economizing constraints, simulating the same sort of limitations that every household and business in the private sector necessarily confronts. To this end, what is needed are not proposals for tax increases but for revisions in the tax structure to make the cost of government more readily apparent to far more of the American population than is now the case.

Table 2. GNP and Budget Projections, OMB Baseline, Fiscal Years 1988-1994

Billions of Dollars

Year	GNP	Revenues	Outlays	Deficit
1988	4,780	909	1,064	155
1989	5,120	976	1,136	160
1990	5,476	1,058	1,185	127
1991	5,848	1,137	1,238	102
1992	6,208	1,209	1,278	70
1993	6,555	1,278	1,315	37
1994	6,888	1,342	1,350	9

Percent of GNP

Year	GNP	Revenues	Outlays	Deficit
1988	100.0	19.0	22.3	3.2
1989	100.0	19.1	22.2	3.1
1990	100.0	19.3	21.6	2.3
1991	100.0	19.4	21.2	1.7
1992	100.0	19.5	20.6	1.1
1993	100.0	19.5	20.1	0.6
1994	100.0	19.5	19.6	0.1

Growth Rates

Year	GNP	Revenues	Outlays	Deficit
1988	7.7	6.4	6.0	3.3
1989	7.1	7.4	6.8	3.2
1990	7.0	8.4	4.3	-20.6
1991	6.8	7.5	4.5	-19.7
1992	6.2	6.3	3.2	-31.4
1993	5.6	5.7	2.9	-47.1
1994	5.1	5.0	2.7	-75.7
1988-1994 Average	6.5	6.7	4.3	-26.9

Source: Office of Management and Budget, *Budget of the United States Government, Fiscal Year 1990*, January 9, 1989. Details may not add due to rounding.

Table 3. Real Federal Budget Deficit in the CBO Baseline (billions of dollars, except as noted)

Fiscal Years:	1988	1989	1990	1991	1992	1993	1994
Federal deficit	155	155	141	140	135	129	122
GNP deflator (%)	3.1	4.2	4.1	4.3	4.1	4.1	4.1
Debt held by public (incl. Federal Reserve)	2050	2190	2331	2469	2603	2732	2853
Inflation impact on debt (debt x deflator)	64	92	96	106	107	112	117
Real Federal deficit (deficit less inflation impact)	91	63	45	34	28	17	5

Source: Congressional Budget Office, **The Economic and Budget Outlook: Fiscal Years 1990-1994**, January 24, 1989.

[1] The differences between the OMB and CBO current services outlays and revenues primarily reflect differing assumptions about GNP growth rates, inflation rates, and interest rates.

[2] An elegant, short paper on this important point, prepared at the Federal Reserve Bank of Philadelphia, is **Federal Deficits: A Faulty Gauge of Government's Impact on Financial Markets**, by Dr. Brian Horrigan and Dr. Aris Protopapadakis.

[3] See Norman B. Ture, "Dealing With The Deficit: Are Tax Increases The Answer?", IRET **Economic Report** No. 19, August 15, 1983, and "A Little More On Crowding Out", IRET **Economic Policy Bulletin**, No. 11, September 12, 1983. Also see Norman B. Ture, "Supply Side Analysis and Public Policy," in **Essays in Supply Side Economics**, David G. Raboy, Ed., Institute For Research on the Economics of Taxation and The Heritage Foundation, Washington D.C., 1982, for an exposition of the distorting relative price effects of taxation and government spending.

Chairman **Rostenkowski**. Thank you, Dr. Ture.

Doctor, we, on this committee—and this is of course the opinion of the Chair—have cut spending programs recommended by the former administration, not with an ax or a hammer, but with, really, surgical instruments. We are down to the bottom line now here.

The President's new suggestion is that we cut $5 billion, as I understand it, in health programs. If I was going to view whether I want to do what the President suggests, or whether I want to go on automatic pilot and go the Gramm-Rudman route, I would prefer the latter, because we are not then involved with a $5 billion cut but about a $2.3 billion cut.

We are trying—and we are going to try as best we can—to cut spending. Now we cannot raise revenues, but we are going to cut spending.

Now we are talking about cutting spending to the tune of about $140 billion. We cannot touch, as far as I am concerned, in any great measure, Medicare cuts. It is a big problem. Social Security, by agreement, is off limits.

Low-income programs are probably down to the bone, at least from, I think, the viewpoint of many members here, at least on this side.

Could you give me kind of a detailed list of how and what programs you would suggest we cut. And not generally speaking now. Where do we go to satisfy the so-called clarion call for spending reductions?

Mr. **Ture**. Let me preface my answer, Mr. Chairman, by recalling that the recommendation that I offer is not for draconian cuts in spending programs, but in continued slowing, or retardation of the growth in spending outlays.

I think the Congress and the prior administration combined have not received anywhere near the credit in the media that they deserve, for what they have achieved. Let me cite a simple statistical comparison.

In 8 fiscal years, from 1973 through 1981, the average annual rate of increase in total Federal outlays was 13.5 percent. In the ensuing fiscal years, through 1988, the average rate of increase in total Federal outlays has been 6.7 percent.

Now that did not just happen. That reduction in the growth rate came about because you and your colleagues—both chambers and both sides of the aisle—working sometimes with, and sometimes against the administration, found ways to pare not the absolute amounts of programs taken in the aggregate, but the rate of their increase, year over year.

It seems to me you have demonstrated that this can be done. I think perhaps Gramm-Rudman-Hollings offered you a kind of spur, and, indeed, a requirement, that in its absence, might have led to somewhat less of an achievement.

But you ought to take great pride in what you have done, and not feel that it is hopeless to continue to make similar progress.

The projection that you will find in CBO, for example, shows that on current services, not changing anything in terms of authorizations of spending, and not changing anything in the tax laws, you would make progress that would not conform with Gramm-

Rudman, as now stated, but which would reduce the Federal budget deficit to well under 2 percent of GNP in the fiscal year 1994.

I think you can do better than that. If you want some specific recommendations, may I submit for the record a list of perhaps two dozen that we have compiled which we will be happy to make available to you.

Chairman ROSTENKOWSKI. Doctor, I will appreciate that no end, if you will give us some specific recommendations wherein we can view just how this can be done, I would certainly appreciate it.

[The information of Mr. Ture follows:]

Spending Reductions Submitted by Dr. Ture and Mr. Entin in Response to Chairman Rostenkowski's Request

The following table displays CBO current services baseline outlays by budget function, and our recommendations for aggregate spending cuts in each budget function in 1990, shown in dollars and as a percent of the 1990 projected functional outlays. In the discussion of each budget function that follows the table, sub-functions or programs areas (capitalized and underlined) particularly deserving of reduction are singled out to demonstrate the feasibility of meeting the target cuts.

Three sections -- Terminations, Government Management, and Credit Reform -- of the (Reagan) Fiscal Year 1990 Budget Documents volume "Major Policy Initiatives" give specific areas for budget cutting. We suggest giving them serious consideration. In addition, some of the specific spending cut options which we favor in whole or in part in the CBO report entitled Reducing the Deficit: Spending and Revenue Options, March, 1988, are discussed under each function as well. The Report is not all-inclusive, but does list specific cuts that would meet, partially, totally, or several times over, the reductions shown in the table. These suggestions could be expanded or trimmed as appropriate. The CBO report groups its proposed cuts into large categories: defense spending (DEF), non-defense discretionary spending (NDD), entitlements and so-called "mandatory" outlays (ENT), agriculture (AGR), and "federal work force," (FWF). The appendix to the volume sorts the options according to budget function.

1990 Cuts by Budget Function ($ billions)

Budget Function	Baseline	Percent cut	Dollar cut
050 National Defense	$305	2%	$6.1
150 International Affairs	16	5	0.8
250 General Science, Space, etc.	13	10	1.3
270 Energy	4	45	1.8
300 Natural Resources and Environment	17	20	3.4
350 Agriculture	15	10	1.5
370 Commerce and Housing Credit	18	55	9.9
400 Transportation	29	7	2.0
450 Community and Regional Development	7	7	0.5
500 Education, Training, etc.	38	5	1.9
550 Health	56	4	2.2
570 Medicare	101	5	5.5
600 Income Security	145	4	5.8
650 Social Security	249	*	0.2
700 Veterans Benefits & Services	31	2	0.6
750 Administration of Justice	10	3	0.3
800 General Government	10	2	0.2
900 Net Interest	182	1	1.8
950 Undistributed Offsetting Receipts	(-)40	5	(+)2.0
Total (baseline contains rounding)	1209		47.8

Reconciliation with Gramm-Rudman-Hollings Deficit Targets

Baseline Outlays	1209	
Baseline Receipts	1069	
Baseline Deficit	141	
Savings	48	
Remaining Deficit	93	vs. GRH Deficit Target 100

Margin: $7 billion, without new tax increases, without sales of unsubsidized, income-earning assets, and without relying on the $10 billion margin (to $110 billion) built into the GRH targets.

RECOMMENDATIONS: SPENDING CUTS BY BUDGET FUNCTION

050 Defense

Cut by 2% of projected $305 billion, $6.1 billion in 1990.

Slash non-essential Military Construction (bases, barracks, recreation facilities, roads, shops). Slow R&D on duplicative or excessively high tech systems that are likely to be uneconomical on a cost benefit basis. Cut Procurement by eliminating poorly performing systems, not by stretching out good ones, which raises unit costs. Trim Personnel in the top-heavy and higher-paid officer corps more than in the lower ranks. Do not cut operations and maintenance; the shelves have been stripped bare to fund big ticket programs, leaving pilots untrained and expensive guns, ships and planes without ammunition, spare parts and personnel.

Set up a procurement office for DoD with permanent personnel, including program directors, independent of the various Services. Model the office on the highly regarded and effective French procurement system.

The various Services pursue independent missions with independent world views, resulting in incompatible hardware and wasteful procurement. More coordination is needed with each proposed weapons system reviewed with the over-all mission of the Department in mind.

Defense procurement contracts should not be renegotiable.

Contractors should not be allowed to ask for compensation for cost overruns. In exchange, DOD should generally not be permitted to change the specifications of weapons systems during the contract; respecifying a program in mid-production adds greatly to the cost.

Procure fewer high tech weapons systems. Subject each to continuous economic cost/benefit checks throughout the proposal and development stages and before procurement. Ensure rigorous, honest operational testing before procurement.

Balance engineering with economics. DoD rushes to produce weapons systems incorporating the latest high tech laboratory developments before they are ready for the field. Testing is often a set-up, and the results are often written up more favorably than the facts warrant. The result is weapons that don't work, break down frequently, and/or cannot be understood by the users. A tragic example is the Aegis, involved in the shooting down of the Iranian airliner, which may have led to the subsequent disaster of Pan Am flight 103. Even when new systems work, they often cost several times as much as those they replace, while delivering only slightly better performance.

Terminate the SSN-21 Submarine program.

The SSN-21 is an expensive, inferior product of an out-of-control procurement effort. It is vulnerable to attack, too large to avoid detection by non-acoustical techniques, twice as costly as the SSN-688 Submarine it will replace, delivers little in the way of increased performance, and is distinctly inferior to current Soviet counterparts.

CBO Spending Options

DEF-01 Cancel procurement of the F-15
DEF-03 Cancel development of the V-22 Aircraft
DEF-06 Cancel Trident refit program
DEF-07 Cancel the small ICBM program
DEF-08 Cancel the manned penetrating bomber program

DEF-11 Reduce funding for research and development (at least temporarily until implementation of a more honest and rigorous approach to systems testing, and safeguards against premature procurement of systems that are too complex to operate and maintain)
DEF-13 Reduce funding for the national aerospace plane
DEF-15 Reduce spending for military construction projects (with emphasis on housing, recreation and non-combat-related building, cuts could exceed the CBO numbers)
DEF-16 Cancel the Navy's plans for new home ports
DEF-18 Retire two aircraft carriers early
DEF-19 Close (more) selected military bases and facilities
DEF-20 Reduce active-duty end strength to 1982 level (but chiefly in the higher ranks and rear echelons, not troop strength)
DEF-23 Increase charges for military hospital care
DEF-25 Restrict retirement reserve benefits

150 International Affairs

Cut by 5% of projected $16 billion, $0.8 billion in 1990.

Focus cuts on International Development, especially the international development banks and the IMF, which push central planning, state ownership and higher taxes on unsuspecting LDCs. Also cut Foreign Information and Exchange Activities.

CBO Spending Options

NDD-02 End the Export-Import Bank direct loan program
NDD-03 Eliminate "cargo preference" and related subsidies to U.S. flag vessels

250 General Science, Space, and Technology

Cut by 10% of projected $13 billion, $1.3 billion in 1990.

This cut is understated vs. requests for additional spending that will be made above current services to fund the Space Station and the Superconducting Supercollider. Modify and defer NASA's over-engineered over-priced Space Station; NASA has obstructed cheaper joint efforts with private sector partners. Cancel the fourth Space Shuttle. Charge commercial users full cost for shuttle launches and divert business to the private launch industry; NASA still undercharges based on current law to thwart privatization in spite of Presidential orders to facilitate development of private sector alternatives. Postpone some space science missions. Postpone the Superconducting Supercollider.

CBO Spending Options

NDD-04 Cancel the NASA International Space Station Program (or better, defer it)
NDD-05 Postpone major new spacecraft development projects in the NASA space science and applications program
NDD-06 Cancel or defer the superconducting super collider

270 Energy

Cut by at least 45% of projected $4 billion, $1.8 billion in 1990.

Slash Energy Supply and Conservation subsidies, and top off the Emergency Energy Preparedness Strategic Petroleum Reserve at a reasonable level before 1990.

CBO Spending Options

NDD-07 Reduce subsidies provided by the Rural Electrification Administration
NDD-08 Reform debt repayment policy for Power Marketing Administrations

300 Natural Resources and Environment

Cut by at least 20% of projected $17 billion, $3.4 billion in 1990.

The government oversubsidizes and undercharges for the Water Resources it creates and the Land and Recreational Resources it manages. Pollution Control should be paid for more by the states and localities.

CBO Spending Options

NDD-09 Change revenue-sharing formula from a gross to a net receipt basis for commercial activities on federal land
NDD-10 Improve pricing for commercial uses of public lands
NDD-11 Increase and expand fees charged for recreational use of National Park Service and other public lands
NDD-12 Increase the harbor maintenance tax (better, adjust it for services performed in each harbor, and consider privatizing the services)
NDD-13 Eliminate federal grants to state revolving funds for wastewater treatment plant construction

350 Agriculture

Cut by at least 10% of projected $15 billion, $1.5 billion in 1990.

Move gradually toward a free market in agriculture. Concentrate farm aid on poor farmers as an anti-poverty program, not an agricultural program. Avoid mandatory set-asides and other artificial controls.

CBO Spending Options

AGR-01 Reduce deficiency payments by lowering target prices
AGR-03 Restrict price support program eligibility and reduce payment limitation
AGR-04 Eliminate generic commodity certificates and establish a new sales price ploicy for CCC-owned stocks
AGR-05 Establish a 2 percent origination fee for CCC nonrecourse loans
AGR-06 Reduce direct lending authority of the Farmers Home Administration for farm ownership and operating loans
AGR-07 Alter management policies at the Farmers Home Administration

NDD-14 Reduce federal support for agricultural research and extension services

370 Commerce and Housing Credit

Cut by at least 55% of projected $18 billion, $9.9 billion in 1990.

This is one of the few functions where OMB and CBO current services estimates diverge sharply. The OMB figure in the Reagan budget for 1990 is $9.7 billion vs. $18 billion for CBO. OMB projects a decline of over $5 billion in FDIC bank rescue operations in FY1990 due to a decline in the number of banks needing assistance relative to 1989. FSLIC outlays are projected to drop by nearly $7 billion in 1990 due to accelerated S&L closings in 1989. The Bush Administration S&L proposal would also lead to less outlay scored in the fiscal year, as off-budget funds from a debt issue would replace budgetary outlays, with only the interest showing in the budget. Either way, there is roughly an $8 billion difference in the current services estimate. Most of the suggested 65% cut in this function is really a recommendation that the OMB baseline figure is more appropriate and should be used instead of the CBO baseline number.

In addition, eliminate Postal Service subsidies. Trim housing credit assistance. Move to risk related FDIC and FSLIC premiums.

CBO Spending Options

NDD-16 End postal subsidies for not-for-profit organizations
NDD-17 Scale back the Rural Housing Loan Program (also affects function 600)
NDD-19 Improve pricing of the electromagnetic spectrum (expand to include existing users, not just unassigned bands)
FWF-04 End indirect retirement subsidy to the U.S. Postal Service

400 Transportation

Cut by at least 7% of projected $29 billion, $2.0 billion in 1990.

Much of this function could be privatized and priced more sensibly, e.g. the air traffic control system. Cut back Ground Transportation -- highways and mass transit subsidies to specific cities.

CBO Spending Options

NDD-20 Reduce federal mass transit aid
NDD-21 Reduce the federal share of highway expenditures and the obligation ceiling on the highway trust fund
NDD-22 Eliminate the airport grants-in-aid program

450 Community and Regional Development

Cut by at least 7% of projected $7 billion, $0.5 billion in 1990.

CBO Spending Options

NDD-24 End funding of the Economic Development Administration and of Urban Development Action Grants
NDD-25 Eliminate or restrict Community Development Block Grants

500 Education

Cut by at least 5% of projected $38 billion, $1.9 billion in 1990.

CBO Spending Options

ENT-01 Reduce subsidies for guaranteed student loans (except item 4 on the list, which eliminates borrowing for students at schools with a high default rate, missing the culprits and hurting the innocent)
NDD-26 Eliminate untargeted funding for elementary and secondary education
NDD-27 Reduce federal funding for campus-based student aid
NDD-28 Reduce Pell Grant funding and increase targeting
NDD-29 Reduce funding for arts and humanities

550 Health

Cut by 4% of projected $56 billion, $2.2 billion in 1990.

Health Research will increase as a result of the AIDS epidemic. Savings are available in Federal matching funds given for state medicaid programs, where the Federal money has encouraged substantial additional services at state discretion.

CBO Spending Options

ENT-02 End federal matching payments for Medicaid recipients eligible only because they receive state SSI supplements
ENT-03 End federal matching in Medicaid for Medicare's premiums
ENT-16 Increase the states' share of AFDC, Medicaid, and food stamp benefit costs
NDD-31 Eliminate subsidies for health professions education

570 Medicare

Cut by 5% of projected $101 billion, $5.5 billion in 1990.

Medicare Part A deductibles and copayments could be set higher to relieve demand pressure on the health system, as could raising the Medicare Part B premium. Avoid extending price controls to physicians. Consider a privatized Medicare, with a need-related "capitation" (vouchers) program under which consumers would have an incentive to shop for the best and cheapest insurance coverage and treatment, letting competition work.

CBO Spending Options

ENT-03 End federal matching in Medicaid for Medicare's premiums
ENT-04 Reduce Medicare's payments for the indirect costs of patient care related to Hospitals' teaching programs
ENT-05 Reduce reimbursements for capital expenditures under Medicare
ENT-06 Reduce Medicare direct medical ecucation payments
ENT-09 Increase Medicare's premiums for physicians' services
ENT-12 Increase Medicare's deductible for physicians' services

600 Income Security

Cut by 4% of projected $145 billion, $5.8 billion in 1990.

Focus on overly-generous mid- and upper-level Federal employee retirement and disability benefits. "Cash out" Housing and Food and nutrition assistance programs to lower administrative costs.

CBO Spending Options

ENT-02 End federal matching payments for Medicaid recipients eligible only because they receive state SSI supplementals
ENT-15 Reduce the subsidiy for nonpoor children in child nutrition programs
ENT-16 Increase the states' share of AFDC, Medicaid, and Food Stamp benefit costs
ENT-17 Count Energy Assistance as income in AFDC and in Food Stamps
ENT-18 Modify provisions of the AFDC program
NDD-32 Shift housing assistance from new construction to vouchers

650 Social Security

Cut by 0.1% of projected $249 billion, $0.2 billion in 1990.

Accelerate already scheduled increases in the normal OASI retirement age, $0.15 to $0.2 billion in 1990.

Under the 1983 Social Security Amendments, the normal Social Security retirement age is scheduled to increase from 65 to 66 at the rate of two months per year for people reaching age 62 between the years 2000 and 2005. Move this adjustment forward to occur for those reaching age 62 between 1990 and 1995. (Also move forward ten years the increase in the retirement age to 67 now planned for those reaching age 62 between 2017 and 2022.)

This proposal would not affect current retirees, and would be far easier and fairer to enact than a cut in the COLA. Those planning to take early retirement at reduced benefits at age 62 could plan to work a few months longer, thereby experiencing no reduction versus current benefit levels, or to save a bit extra to make up for the slight reduction in per capita benefits that would otherwise occur (1.4% for someone retiring at age 62 in 1990, 8.3% for an age 62 retiree in 1995).

For long term savings, reduce the growth of real initial benefits for future retirees by letting the replacement rates (ratio of benefits to pre-retirement income) slip gradually over time as real incomes rise. (No 1990 impact.)

Alter the method of indexation of the current formula which determines initial social security benefits upon first retiring (the "primary insurance amount" or PIA). Switch from the current overly-generous wage-indexing to the lesser-of-wage-or-price-indexing of the "brackets" in the PIA formula. The difference would be very minor near term, but would grow continuously over time. Real benefits per retiree, which triple over the 75 year planning period under the current formula, would still nearly double. Do not tamper with the cost-of-living adjustment (COLA) that protects these benefits after the retiree begins receiving them (as in CBO options ENT-21 and -22). (This method of adjusting replacement rates is more gradual and less likely to cut real absolute benefits near term than CBO option ENT-23, while saving more over time.)

It is far preferable to slow the very rapid growth in initial retirement benefits being promised to future retirees under current law than to try to reduce benefits to those already retired by attacking the COLAs. It is better to set an affordable level of initial real benefits, and then to protect them fully against inflation, than to allow an unaffordable level of initial benefits, and then cut them back through the unpredictable forces of inflation by limiting the COLA. COLA freezes or cutbacks generate acute anxiety as the very old worry about outliving the purchasing power of their benefits. A sensible formula for determining PIAs would avoid all this distress.

CBO Spending Options

ENT-24 Eliminate Social Security benefits for children of retirees ages 62-64 (also affects function 600)

700 Veterans Benefits and Services

Cut by 2% of projected $31 billion, $0.6 billion in 1990.

CBO Spending Options

DEF-24 Enact DoD's proposed changes in the new GI bill
ENT-25 End certain Veterans' Compensation payments for those with low-rated disabilities
ENT-26 Raise the loan fee for Veterans Administration Guaranteed Housing Loans
NDD-35 Close down inefficient or underused units in Veterans Administration hospitals

750 Administration of Justice

Cut by 3% of projected $11 billion, $0.3 billion in 1990.

CBO Spending Options

NDD-36 End funding for the Legal Services Corporation

800 General Government

Cut by 2% of projected $10 billion, 0.2 billion in 1990.

Certain payments to states reflecting policies discussed in other functions would be scored under General Government.

900 Net Interest

The spending cuts outlined above would save about $1.8 billion in interest in 1990.

Issue indexed bonds. Cease long bond issues when interest rates are high.

In 1981, Treasury issued fixed coupon 30 year bonds, uncallable, at interest rates exceeding 13%. Within two years, inflation and interest rates had collapsed. By 1986, long bonds could have been sold at less than 8%. As early as 1983, short term rates on Treasury debt were below 9%. It is not possible to tell how rates will fluctuate in the future. However, compared to a policy of "bills only," the issue of long term debt in the 1980's has added over $10 billion a year to current net interest payments. Indexed bonds would have carried a much lower coupon of roughly a 2% to 3% real interest rate. As inflation fell over the 1980s, annual interest payments (or accrued interest liability, depending on how the bonds were structured) would have fallen to match.

920 Allowances and 950 Undistributed Offsetting Receipts

A number of policy initiatives discussed under other sections would be scored as allowances or offsetting receipts. These would include adjustments to federal civilian pay and federal employee health insurance premiums (allowances) and sale of the unassigned electromagnetic spectrum and other assets (undistributed receipts).

The Federal work force needs trimming, and is overpaid at some levels. However, employees in certain technical areas and Federal judges are not receiving competitive salaries. Departments need more flexibility in creating job categories and adjusting pay for circumstances and merit. Employees should have more flexibility to choose deferred payment in savings plans instead of current pay. Formulas will not work as well here as personnel cuts.

Mr. **Andrews**. Mr. Chairman. Excuse me, Mr. Chairman.

Chairman **Rostenkowski**. Yes, Mr. Andrews.

Mr. **Andrews**. If the gentleman would yield. I would just be curious, before we move on, if he would enumerate a few of those for us this morning, just some specific programs.

Mr. **Ture**. Mr. Andrews, much of this material was compiled in response to a request that we received from one of our friends, and I do not have the list handy. However, I will be happy to provide it, in detail, for you.

One of the recommendations, I might simply add, is that I believe that there has got to be room for an awful lot of economizing in the defense budget, and since that is the single largest outlay portion, I would certainly say we ought to be able to start there, and make some very substantial reductions.

Chairman **Rostenkowski**. Well, Doctor, evidently that word has reached downtown, too, because as I understand what I am reading in the press, the defense budget has no increases, and so the President will be here tomorrow night, and reflecting on that.

Mr. **Ture**. May I say, Mr. Chairman, that I fervently hope that zero increase in that outlay is not simply on paper, and that the President's dictum in this respect will have the effect of some very careful reconsideration in the Department of Defense about where spending priorities really belong.

Chairman **Rostenkowski**. Thank you.

Mr. Bergsten, or Dr. Lawrence, how fast, in your opinion, how fast can the trade deficit be lowered during the next several years, assuming that the budget deficit is reduced along the Gramm-Rudman path? Could you give us an idea?

Mr. **Bergsten**. My view would be that they can come down at about parallel rates. They happen to be roughly at similar levels now. I would advocate setting a national goal of eliminating both deficits over the next 4 years. You have your Gramm-Rudman budget target for the next 4 fiscal years. I would add to that a target of eliminating the current account deficit over the next 4 years. That would add to the additional credibility of the plan in that it would occur within the term of a sitting President, and therefore an indication from that end of Pennsylvania Avenue to follow that timetable would be more credible than something that continued into a future administration.

In numerical terms, such a plan would take each deficit down by $35 to $40 billion per year. Economically it works out very nicely, because by reducing the budget deficit, with less Government spending, for example you free up domestic resources. Those resources can then be exported to reduce the trade deficit without adding inflationary pressure to the economy.

So the economics work out nicely. I think the politics also work out nicely. The credibility of the whole affair is crucial for the markets to and avoid a crash of the dollar, and therefore that is the goal I would suggest.

Mr. **Lawrence**. I would roughly agree with what Dr. Bergsten has said.

Chairman **Rostenkowski**. Just to conclude my participation in this discussion, Gramm-Rudman targets—and I speak as what I anticipate the suggestions from this administration will be—Gramm-Rudman targets do not frighten me at all.

As a matter of fact, should we come to that crisis that we always find ourselves in, as far as the participation of my colleagues on this committee, taking into consideration the fact that there is a safety net, it is much easier for us to watch Gramm-Rudman take effect with respect to what is going to be recommended, than it is for us to try to legislate in the area.

I do not like automatic pilot. I do not like it any more than anyone else does that loves legislating. But I am afraid that we are finding ourselves in a position of only legislating when there is a crisis.

You know, the chemistry of the legislator—I might add, not so much in this body, but in the body that serves as an equal part of the congressional process—is something that I find a little disappointing, when members are not willing to take a posture, and stand up and bite the bullet, take the hard vote, recognize your responsibility.

But I do not like automatic pilot, and I am sure this administration, should we go to sequestration, could be viewed by the public, via the media, as not being able to govern.

That is the only reason why, considering what is going to be recommended, I think that we are going to come to some compromise, because everybody that is elected likes to feel that they are participating in their responsibility, at least the responsibility that their constituents send them here to shoulder.

So, I will be interested, Dr. Ture, and I just want to personally thank you all for joining us this morning.

Mr. Bergsten. Could I just add one sentence on what you just said? I am afraid that if you rely on automatic pilot you may get your crisis, because the markets——

Chairman Rostenkowski. Well, Mr. Bergsten, we have been relying on the crisis, we have been doing that for the 8 years that I have been here as chairman of the committee. That is sad, but it seems as though we wait for that so-called crisis in order to move. You know, I want to add that this committee has met its responsibilities every time that the Budget Committee has made recommendations, and given us numbers.

We reserve the right, always, to create the legislation, but we do not object to the fact that you give us numbers or the committee will give us numbers to work with.

And so I do not like crisis either, Mr. Bergsten. You know, I am willing to go back to my constituency and stand before them, trying to explain, you know, what the measure is that, in the long-run, is in the best interests of the country.

We are going to go through some perilous times here. We have got members of this body that are going to offer pie-in-the-sky programs that are very expensive. Unless you are on the committee that has to raise those revenues, you do not realize what a burden it is.

And if there is anything that I dislike with respect to serving in Washington, it is raising the expectations of the American people and then not being able to fulfill what you suggested is necessary.

I would rather make a minimum commitment but honor the commitment, and I think that is where we, in the legislative process, have a fault. Mr. Archer will inquire.

Mr. **Archer**. Thank you, Mr. Chairman.

In the opinion of you gentlemen—and I want to compliment each of you on very concise and constructive presentations—in your opinions, are the Gramm-Rudman targets that we currently have in the law at appropriate levels?

Mr. **Lawrence**. Mr. Archer, I believe that they are a reasonable pace for the reduction of the Federal budget deficit. It works out to somewhat below 1 percent of GNP. We met these in 1987, and I think it is well within the capacity of the economy to adjust, both in terms of the trade deficit, to come down, to provide some of the offsetting demand growth, and more generally for spending in the economy to absorb that kind of adjustment.

So I think since it is imperative to set ourselves on a course to bring down the budget deficit, this kind of pace seems to me a reasonable pace to move at.

Mr. **Bergsten**. I agree.

[The following was subsequently received:]

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February 28, 1989

The Honorable
Bill Archer
US House of Representatives
Washington, DC 20515

Dear Mr. Archer:

During my appearance before the Committee on February 8, you asked what additional action the Congress could take to help promote decisive reduction in the trade deficit. My reply focused on reducing the budget deficit, and on implementing the new trade legislation to further open foreign markets.

I believe that you could take several major initiatives in addition, however, to promote US exports. I stress new export promotion steps for two reasons: exports must provide the bulk of the improvement in our trade balance, which need to total about $150 billion over the next four years, and present policy fails miserably to support the export effort--and, in many cases, actually deters it.

It is ludicrous for the Export-Import Bank to run out of funding--as it did last summer--when we are in the midst of an export boom and need enormous further gains. In addition, as you know from your work on the Omnibus Trade Act last year, many disincentives to our exports remain in present legislation--ranging from an outright ban on most sales of Alaskan oil to broad "foreign policy controls" which permit administrations to restrict exports for a wide variety of reasons. And the US negotiating position in the Uruguay Round should be beefed up considerably, to enhance the prospect for reducing foreign barriers.

The Honorable
Bill Archer
Page Two

I therefore propose that the Congress turn its attention to an "Export Promotion and Removal of Disincentives Act," and encourage the Administration to expand its efforts in Geneva. Enclosed is the section of my recent book, America in the World Economy: A Strategy for the 1990s, which outlines my thoughts on these issues. I believe it is the most promising and important effort which the Congress could make on the trade policy front in 1989 and 1990.

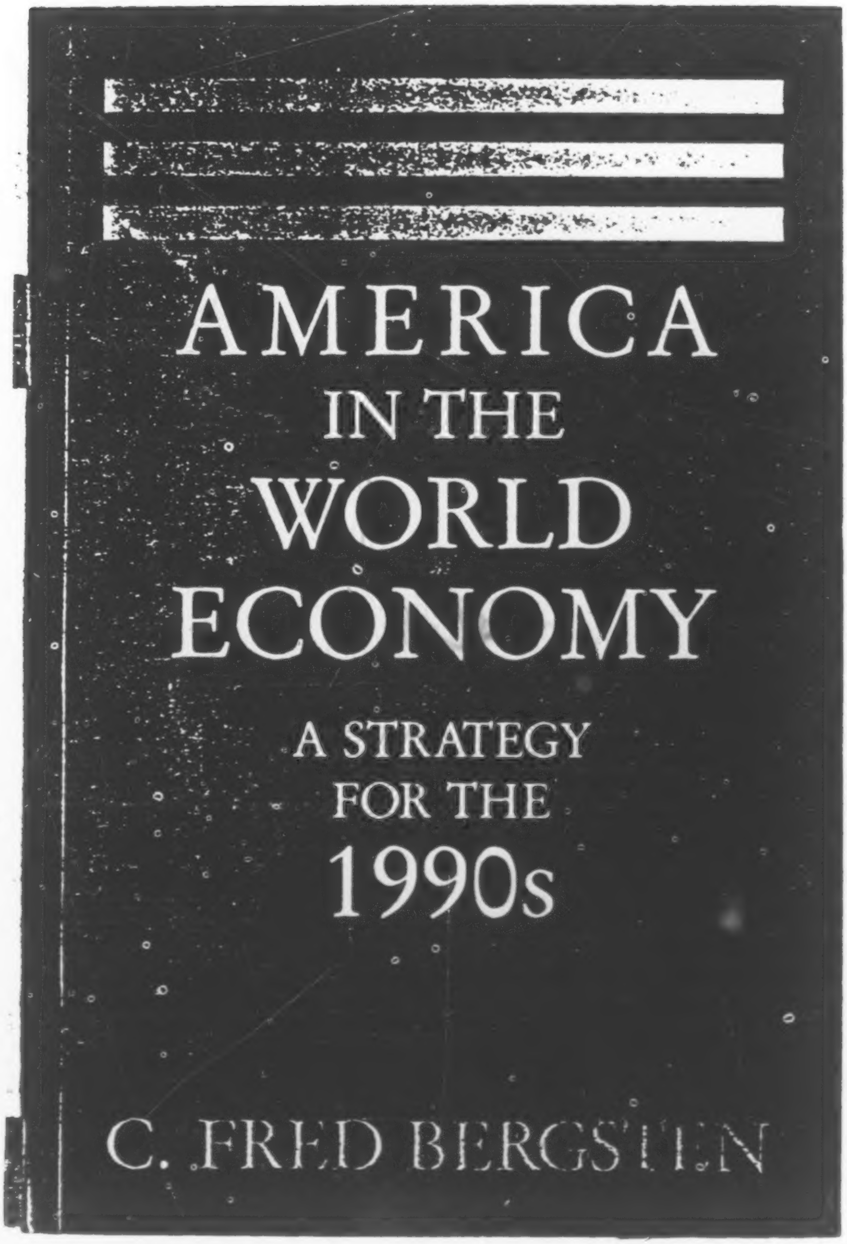
I would of course by happy to discuss these matters with you further, and apologize for not tabling them during the hearings on February 8. I have sent copies to the other Members of the Committee on the thought that the subject might be of broader interest, and hope that you will want to pursue it in the coming months.

Sincerely,

C. Fred Bergsten
Director

Enclosure

cc: Chairman Rostenkowski
Members of the Committee
on Ways and Means



AMERICA
IN THE
WORLD
ECONOMY

A STRATEGY
FOR THE
1990s

C. FRED BERGSTEN

by countries that emulate the United States) trimmed their export earnings.[7]

Import restrictions would also be likely to fail because many countries would emulate the American restrictions and/or retaliate against them. The European Community has already adopted a "New Commercial Instrument" that is the mirror image of Section 301 in US trade law, and its new emphasis on sectoral "reciprocity" was inspired in large part by the American authors of that concept. The ultimate result of the adoption of new protective barriers by the United States—which is now enjoying a prolonged export boom and has been the world's most successful creator of new jobs over the past six years—would almost surely be a proliferation of trade barriers throughout the world.

One trade policy proposal that has received extensive attention is an import surcharge, which would seek to attack the twin deficits simultaneously by cutting imports and raising budget revenues through "taxing the foreigners" (although the surcharge's tax burden would fall mainly on American consumers). This particular device would have the same adverse effects mentioned above, but it is even more likely to trigger retaliatory foreign responses because of its breadth and its obvious rejection of international cooperation. If applied to Third World debtor countries, an import surcharge would almost certainly cause a financial crisis; they and Canada (because of the Free Trade Agreement [FTA] if ratified) would have to be exempted, thereby reducing the maximum coverage of the device to about two-thirds of total US imports.

The effect of an import surcharge on the economy would be perverse, because the implied US effort to escape from responsible domestic measures and international cooperation could drive the dollar down sharply in the exchange markets and bring about a hard landing.[8] Its fiscal impact would also be perverse, because, as a temporary measure that would almost certainly be phased out over time, it would make a declining contribution to budget correction, whereas steps are needed that will provide increasing returns over a period of several years.

Another recent trade proposal calls upon other countries, notably Japan, to reduce their bilateral surpluses with the United States to a specific level within a fixed period of time (US House of Representatives 1986; Kissinger and Vance 1988; Prestowitz 1988). In addition to generating the usual costs of trade restrictions, this "results rather than rules" approach would force the "partner" countries to cartelize their entire economies to control trade flows in a way that would enable them to comply—hardly a desirable outcome for the United States. It would also greatly enhance the credibility and frequency of "managed trade," an international game which the United States is peculiarly ill-equipped to play against Japan and other far more homogeneous societies that have been engaged in such activities for a considerable period of time (Lawrence 1988). And even if it were successful in reducing US deficits with the countries in question, it has the fatal flaw of any bilateral approach—leaving other countries free to improve their positions with the United States, which would obviate any net gains in the American trade balance.

The United States needs a world of expanding markets to eliminate its current account deficit, and it is now primed to take full advantage of them. Achieving such an outcome will require the use of tough American negotiating tactics to open markets, including the carefully targeted use of threats to close US markets on a selective basis. But the objective must be clear: maintenance and expansion of an open trading system to permit the US correction to succeed.

EXPORT PROMOTION MEASURES

The marketing reentry component of the trade policy strategy will require a series of specific policy steps by the administration and

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[7] Any adoption of substantial new US trade barriers against Latin American products would be likely to reignite the debt crisis, both because it would impair these countries' ability to service their borrowings and because of the political implications of such a step by the country whose banks were receiving much of the debt service. Protectionist action by the United States would thus risk renewed financial instability as well as undercut the trade adjustment effort.

[8] The surcharge adopted by the United States for four months in 1971 was aimed at achieving devaluation of a clearly overvalued dollar within a system of fixed exchange

s where it was widely perceived that dollar devaluation was possible only with the agreement of the major foreign countries. This is very different from today's environment of flexible rates with the United States near full employment and facing a pickup of inflation concerns, where the United States can push the dollar down quite easily whenever it wants to do so but must avoid a sharp depreciation in the absence of complementary policy changes at home and abroad.

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Congress, along with a large dose of exhortation by top officials, including the President. The goal is to get American industry to focus on the great opportunities presented by foreign markets following the currency changes, particularly markets in surplus countries that maintain rapid growth of domestic demand, as proposed above. The potential of foreign markets needs to be contrasted with the likely modest growth of American domestic demand during the years ahead.

One potentially important tool for effective government support of the export drive is the Export-Import Bank (De Rosa and Nye 1980). It can provide liquidity for export finance, especially to buyers in Third World and Eastern European countries where private lenders have largely withdrawn because of the debt problem. It can provide attractive interest rates to help induce American firms to resume their export efforts. It can help ensure that American exporters are not at a disadvantage because of the aggressive financing programs of other trading countries.

The programs of the Bank were severely truncated by the Ford administration in the mid-1970s, but a four-fold expansion of its lending activities during 1977–81 undoubtedly contributed to the American export boom of that period.[9] The Reagan administration sought to abolish the Bank and succeeded in again turning it into a very minor actor (Stockman 1986, 113–114). The Bank in fact ran out of new lending authority in mid-1988 and had to suspend its direct loan program in the middle of an export boom. Hence a major export promotion tool was shelved just when it became most essential, and when it could do much to enhance further the competitiveness of American industry.

The new administration and Congress should substantially expand the role of the Export-Import Bank. First, its lending program should be sharply increased. Expanded authority for direct loans would enable the Bank to extend lines of credit to major foreign buyers, as the Japanese and some European export finance agencies do, strengthening the competitive position of American suppliers.

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[9] The Export-Import Bank has played major roles in promoting US trade (and foreign policy) objectives during several periods in its history. See Rodriguez (1987), especially Chapter 1.

Second, the guarantee program of the Bank—where a large amount of unused authority exists—needs to be utilized much more aggressively and creatively. Many US banks need to be encouraged to enter (or reenter) export financing activities, which will in turn encourage more companies to focus on export markets. New sources of funding can be drawn into export finance, and new techniques for using the guarantee authority need to be developed. Third, the Bank should play a major public and private role in conveying the export message to the business community. It thus needs to be provided with dynamic leadership, along with increased and more professional staff, during the coming period.

There has been considerable tightening of the Agreement on Guidelines for Officially Supported Export Credits, the international "consensus" or "gentleman's agreement" to limit export finance subsidies. But there remains a problem of subsidization through mixed credits, which blend export finance and concessional foreign assistance to provide extremely attractive terms to potential customers. The administration and Congress set up a "war chest" in 1986 to defend US exports against this practice for the next two years, and extended the program for a third year in the Omnibus Trade Act. But the size and duration of the program are far too limited to deter Japan, France, and others from using mixed credits, which have a major impact on many large capital projects around the world, where the absence of competitive US finance has often discouraged American firms from bidding for the business. Elimination of mixed credit subsidies should rank near the top of the trade negotiating agenda of the new administration. This effort will succeed, however, only if Congress approves a sharp expansion in the "war chest," thereby providing convincing evidence that the United States will no longer give up such business without a serious effort.

Changes in the budgetary treatment of the Export-Import Bank would facilitate this set of proposals. Congress now authorizes and appropriates annual lending levels for the Bank, and loans are counted as budget outlays even though they are almost always repaid. Conversely, losses due to effective interest-rate subsidies are not revealed in the budget (although they can be found in the annual reports of the Bank itself). This budget treatment needs to be reversed, to focus on the Bank's net profits (or losses) rather than on its gross lending level, in an effort both to reveal real costs (if any) to the taxpayer and to avoid accounting barriers to desirable program modification.[10]

It would also be desirable to move Eximbank out of the "foreign affairs" part of the budget (function 150), creating instead a new "export support" function in which the Bank's programs would be grouped with similar efforts of the Department of Commerce, the Commodity Credit Cooperation, the Overseas Private Investment Corporation (OPIC), and other agencies scattered throughout the government. Setting up a separate category for export promotion would indicate the high priority attached to it by the administration and Congress. It would also more accurately characterize the Bank, which is no longer primarily an instrument of foreign policy. Since the Bank would be the largest element by far in such a function, it would be placed in a strong position to assert leadership of the export promotion campaign.

The United States can also promote its exports effectively by significantly increasing the role and funding of the international financial institutions—especially the World Bank, Inter-American Development Bank, and International Monetary Fund. These institutions serve a number of key US policy objectives, as developed in detail in Chapter 7. In particular, they promote faster economic growth, relaxation of acute shortages of foreign exchange, and more liberal trade policies in the large debtor countries in Latin America. These countries are major markets for US exports, and can become even better markets once their debt problems are resolved and steady growth resumes. The international institutions can play a central role in this effort, and they can do so in an extremely cost-effective manner with very small budget outlays from the United States.

In addition, the new administration and Congress can take a large stride toward improving the American trade position by launching a concentrated attack on the numerous export disincentives that continue to pervade US law and practice. These disincentives include explicit export controls that have been imposed for reasons of national security, foreign policy, environmental protection, and short supply (which is sometimes an excuse for pure protectionism, as when the domestic maritime industry won controls on Alaskan oil exports). Other disincentives include the use of economic sanctions in pursuit of foreign policy goals, such as the grain embargoes of the 1970s and the gas pipeline effort of the early 1980s. These sanctions have hurt US exports and have reinforced the reputation of the United States as an unreliable supplier, generally with modest if any foreign policy payoffs (Hufbauer and Schott 1985b). The results are sometimes the same with policies that seek to punish foreign corrupt practices or restrict arms sales to certain countries, and perhaps also with some tax policies (such as those affecting income earned by Americans working abroad).

The goals of these various measures are defensible when viewed individually and in their own special contexts. However, taken together, and weighed against the imperative of external adjustment for the United States in both the short and longer runs, policies like these can do considerable harm to US national interests. The Omnibus Trade Act eliminated some of these self-imposed barriers, particularly by restraining the use of export controls for foreign policy purposes (Bonker 1988). But much more should be done, and the scheduled renewal of the Export Administration Act in 1990 provides a natural opportunity.

The new administration should adapt its own policies and procedures accordingly, and work closely with the Congress to devise an "Export Promotion and Removal of Disincentives Act." This legislation could include the proposed increases in Eximbank and other export promotion programs, and revisions of current limitations on US export capacity. A logical successor to the Omnibus Trade Act, such an initiative would stress what the United States could do on its own to promote its international competitiveness.

In addition to spurring exports through its own institutions, the new administration will need to continue the aggressive effort launched in September 1985 to attack foreign barriers to American exports. Numerous such barriers continue to exist, some in violation of existing GATT rules. Attacking them through both bilateral and multilateral channels—including in the Uruguay Round, as discussed in the next section—must be an integral element of any comprehensive adjustment strategy for the United States. In particular, the United States must make it unambiguously clear that it will respond

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[10] In FY 1986, estimated subsidies were 2 percent of guaranteed loan commitments and 11 percent of direct loan obligations for a total estimated cost of $178 billion. See Office of Management and Budget (1987, F-35/37).

8B

immediately to the threat or the imposition of any new barriers against its exports. The United States can only keep markets open for its export drive if it is willing to retaliate in all cases in which a country contravenes the international rules or fails to pay full compensation through an offsetting reduction of other trade barriers.[11]

In addition to their substantive merit, these export promotion efforts link directly to another key objective of the overall strategy: a successful Uruguay Round. The linkages come from the domestic political reality that administrations can carry out open trade policies far more successfully if they are able to mobilize outward-looking "export politics" to counter domestic interest groups committed to inward-looking "import politics" (Destler 1986, 15–16, 96, 208). As noted above, import suppression would be a wholly ineffective (indeed counterproductive) alternative to export expansion in the current context. However, the two are frequently seen as alternative strategies. Hence a major export push by the administration will be helpful, perhaps essential, in achieving the domestic consensus necessary to support a trade strategy of opening rather than closing markets.

There is also an important international reason for an explicit American export campaign. There is a widespread view around the world, perhaps most prevalent in Asia but apparent in Europe and elsewhere as well, that the United States does not care about exports and is unwilling (or unable) to make a major effort to acquire and maintain foreign markets. This view sometimes leads to two conclusions: that the United States "will never be able to balance its books" and that it is thus futile to take steps to help it do so; and that the United States is basically trying to get others to initiate measures to achieve the correction instead of taking responsibility itself. Chapter 2 argued that this first conclusion is wrong, and that the underlying competitive position of the United States is quite strong. The second conclusion would be countered by the adoption of the program recommended in this book.

Nevertheless, both views persist and must be countered if the United States is to obtain the foreign cooperation that is necessary for the proposed strategy to succeed. Export campaigns have been standard practice in most nations for many years. The adoption of a serious export program in the United States would be an innovation, despite previous rhetorical gestures in its direction, and it would earn the United States increased respect abroad. It would thereby enhance US chances of earning the cooperation of others and restoring American leadership more broadly, as well as provide some support for the trade correction itself.

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[11] Due to its consensus method of decision making, the GATT almost never formally authorizes retaliation (because the offending party can veto action against itself). The United States should therefore retaliate unilaterally whenever a GATT panel finds that a violation has occurred. The GATT system should be modified in the Uruguay Round to make such a practice universally applicable.

NEGOTIATING TRADE LIBERALIZATION

The second key part of the trade policy strategy is maximum liberalization of trade around the world. History demonstrates the validity of the "bicycle theory": if trade policy does not move toward the greater openness that is in the general interest, it will topple in the face of protectionist pressures.

As noted above, these pressures will be especially acute during the next few years in countries whose trade surpluses are coming down (or whose deficits are rising) as the counterpart to the American current account improvement. Protectionist sentiment could be strong in the European Community, as its members take the difficult steps to "complete the internal market" while experiencing a sharp fall in their external balances. The pressure to protect will also remain severe throughout Latin America, as countries there search for additional ways to earn and save foreign exchange. Resistance to liberalization has even begun to grow in Korea and Taiwan, given the rapid pace of adjustment required there because of the magnitude of their surpluses (as a share of GNP).

The United States thus needs to generate liberalizing momentum simply to avoid the risk of increased barriers abroad—which would frustrate its own trade correction—as well as to pursue the increased market access that would enhance its export push.[12] The central tactical issue is whether to focus primarily on the multilateral negotiations of the Uruguay Round or to devote further attention to bilateral agreements like the United States–Canada FTA (or perhaps regional arrangements, notably in the Pacific).

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[12] Implementation of the Free Trade Agreement would achieve that objective with Canada, the largest trading partner of the United States, which would be precluded from putting up new barriers to US exports even if its total external position were to deteriorate sharply.

A successful Uruguay Round is essential. Key US export sectors, particularly agriculture but also a number of high-technology and services industries, simply could not obtain the scope for increased export opportunity they need even with an extensive series of bilateral pacts. Key functional issues such as subsidies cannot be handled adequately on a bilateral basis, as the United States discovered in the successful negotiations with Canada, its largest trading partner (Schott 1988). It is also essential to engage the European Community in a process of global trade liberalization to remove any temptation it might have to pass on the price of internal deals to outsiders.

In any event, it is doubtful that other bilateral FTAs comparable to the one with Canada are feasible. Perhaps a few sectoral arrangements with Mexico, and consultative mechanisms with Japan and others, could be negotiated. There is a possibility of broader arrangements, notably a "G-2" between the United States and Japan, to deal with macroeconomic and monetary coordination (Bergsten 1987a; Baucus 1988). But there is little possibility of meaningful trade liberalization through this approach. The United States should put its major international trade emphasis on a successful Uruguay Round.[13]

The basic strategy in the Uruguay Round should be the same as in past rounds: "reciprocity at the margin." Concessions are traded, and roughly quantified, in terms of reductions in protection from levels that applied at the outset of the negotiations. As in the past, trade-offs among sectors will be necessary to achieve substantial liberalization. This is because different countries, depending upon their competitive abilities and domestic politics, are willing and able to liberalize further in some sectors than in others, so the sectoral patterns of liberalization will differ from country to country.

The alternative approach of "sectoral reciprocity," in which similar degrees of market access are sought for individual industries, would be far less likely to achieve the degree of market-opening that is now so important to the United States. This approach would limit the magnitude of the total package to the extent of liberalization agreed upon within each sector, which would reflect the wishes of the least competitive country in each. This reduces opportunities for larger intersectoral trade-offs. Sectoral reciprocity can ultimately be achieved by a total freeing of trade across the board, and the traditional emphasis on "reciprocity at the margin" provides by far the most promising route to a "level playing field."

The primary objectives in the talks should remain largely similar to those originally pursued by the Reagan administration: reduced barriers and distortions to trade in agriculture; new rules for services, intellectual property, and foreign direct investment; improvements in the existing codes, especially those covering subsidies and government procurement; and a sharp improvement in the effectiveness of the GATT in managing the trading system. The new administration will have to establish clear priorities in each of these areas, deciding what it wants and what it is willing to pay for foreign concessions. In agriculture, for example, the Congress will be loath to accept liberalization of the current US quotas until the President outlines what he might realistically expect to get in return.

The new administration, working closely with the Congress to establish US negotiating priorities and potential concessions, could profitably make a few changes in the US negotiating stance for the talks. On agriculture, it could seek a less sweeping and thus more widely acceptable arrangement than the current goal of total elimination of all government supports.[14] In contrast, it should propose the elimination of all tariffs on trade in industrial products among the developed countries by 2000—which is a realistic goal. To induce greater liberalization by key developing countries, the United States should propose giving them subsequent credit in the GATT for any unilateral reductions in barriers adopted as part of structural adjustment programs worked out with the IMF and the World Bank, as long as the trade liberalization is maintained (Hufbauer and Schott 1985a, 8–11).

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[13] By contrast, Choate and Linger (1988, 91–93) argue for a "tailored-trade approach [that] would elevate bilateral and plurilateral negotiations from a secondary to a primary role." They recommend seeking immediate bilateral negotiations with Japan, South Korea, Taiwan, and Germany, which with Canada account for two-thirds of the US trade deficit, with the aim of reducing the current imbalances. However, their use of the US–Canada FTA as a model for reducing bilateral imbalances is simply a misreading of the agreement; that issue was never even discussed, let alone included in the aims of the agreement. Moreover, while Choate and Linger concede that "a system of global trade based exclusively on bilateral or plurilateral relations could easily create so much fragmentation and discrimination that net global trade would be reduced," they ignore the inevitability of retaliation against agreements that simply rearrange trade flows for the benefit of participants to the detriment of those excluded—such as those proposed in some quarters in Korea and Taiwan for the explicit purpose of shifting those countries' imports from Japan to the United States, which its proponents hope would remove the pressure to reduce their global surpluses.

[14] See Hathaway (1987); *Reforming World Agricultural Trade* (1988); and Paarlberg (1988).

Most importantly, the new administration could give a dramatic boost to the US bargaining effort by offering to begin a gradual long-term liberalization of the international Multi-Fiber Arrangement (MFA). It should indicate a willingness to phase out its import controls on textiles and apparel, perhaps over 10–15 years, if the textile exporting countries would provide reciprocal liberalization of their own import controls, initially in the textile sector itself and then more broadly, and if the other major importing countries did likewise. Normal attrition in the industry would offset most of the employment losses that would result, and substantially increased government assistance—self-financed by auctioning rather than giving away the quotas as they are phased down, as described below—could further ease the transition for affected workers. The bicycle theory is nowhere clearer than in textiles: in the absence of efforts to liberalize this sector, protection steadily increases and bills calling for even more restrictive quotas continue to pass the Congress despite the extensive regime already in place and the improved conditions in the industry.[15]

By putting textile restrictions, its most extensive program of protection, on the table, the United States could trigger a quantum leap in the substantive content of the Uruguay Round and assert a strong leadership position. The American negotiating effort would be further bolstered if the United States also worked to ban "voluntary" export restraint agreements and other "gray area" protectionist devices. Such a ban would be very much in the interest of the United States itself, as described below.

These steps would challenge both the industrial countries and the LDCs to up their antes as well. In particular, agreement on a phased elimination of the MFA and elimination of "gray area" controls should permit the negotiation of a meaningful Safeguards Code during the round.[16] Such a code is a high priority for most LDCs, so its completion could unlock the door to concessions from them on "special and differential" treatment. The "S&D" provisions have enabled LDCs to apply far-reaching restrictions of their own, and they have frustrated all GATT efforts to achieve meaningful liberalization of LDC trade barriers. Since many LDCs represent large and potentially growing markets for US exports, inducing them to liberalize would be a major gain for the United States (as well as for them and for the world trading system as a whole).

The United States should also continue to press for improvement in the functioning of the GATT system. The United States has a major stake in the better operation of the international institutional framework because of its growing inability to resolve disputes unilaterally—especially in the trade area, where the European Community accounts for a much larger share of the world's activity. If most trade disputes could be handled effectively in the GATT, there would be much less pressure, both internationally and within the United States, for overt trade management by governments. The record of the GATT in recent years is not bad.[17] However, it has failed to resolve several major trade conflicts, particularly in agriculture, where the rules themselves are inadequate. There is a close relationship between improving the rules and strengthening the institution, and the two goals should be pursued together in the Uruguay Round.

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[15] The underlying analysis and proposal are in Cline (1987b), who shows that the present textile quotas cost US consumers about $20 billion annually, much of which falls on lower-income groups and thus has a regressive impact on the country's income distribution. His conservative estimates suggest a consumer cost of about $82,000 for each job saved directly in the apparel industry and $135,000 per job saved directly in textiles.

[16] The goal of the Safeguards Code is to limit all import controls to measures that are temporary and degressive, outlaw "gray area devices" such as "voluntary" restraint arrangements—of which the most egregious is the MFA—and ban discrimination in the application of trade restraints. LDCs are the major targets of most such practices, and successful completion of such a code is therefore at or near the top of the priority list for most of them in the Uruguay Round (as it was in the Tokyo Round).

[17] In 1984, GATT members agreed on guidelines of 30 days for the establishment of a dispute settlement panel and three to nine months for it to complete its work. According to Horlick, Oliver and Steger (1988), GATT panels since then have become faster even though the guidelines are not binding. In the first half of 1988, GATT dispute settlement panels recommended liberalization or elimination of Canadian barriers to certain types of fishing in the Pacific, Canadian provincial taxes on beer, wine, and liquor, and Japanese barriers to 12 categories of miscellaneous agricultural products. Canada and Japan eventually accepted the GATT reports and either implemented the recommended liberalization or negotiated a compromise acceptable to all parties (*International Trade Reporter*, various issues).

The timing of the round is important, and is comparable to that of the Tokyo Round of the 1970s. That effort was launched with the Tokyo Declaration (1973). The United States received congressional authorization to negotiate in 1975, but the round could only be completed three years later (1978) by a succeeding administration because other countries would make meaningful concessions only to the American team that would be there at the conclusion. The Uruguay Round was launched in 1986, preparatory work and a mid-term review will be concluded in 1988, negotiating authority has been obtained from Congress, and a major push by the new administration could result in a similarly successful outcome.

A target date of 1990 has been set for completion of the round. This may be feasible, and it would be highly desirable to complete the negotiation on agriculture before Congress writes the new American farm legislation, scheduled for 1990. However, this would require the completion of most or all of the entire package, because agriculture is such a central element. On the other hand, the likely acceleration of the European integration effort as 1992 approaches suggests the merit of continuing the GATT talks (and keeping the bicycle in motion) at least until that year. This would maintain the pressure on the Europeans to avoid internal bargains that would be inconsistent with global liberalization.

The best outcome for the United States would be a two-part Uruguay Round, including an initial package dealing mainly with agriculture, largely finished by early 1990 (with enough progress made during 1989 to have a substantial effect on congressional deliberation on the farm bill), and a final deal in 1992 (to ensure ratification by Congress during the term of the same administration that negotiated it, as in the Tokyo Round). The agricultural component could develop in two stages: agreement in 1990 on short-term measures and a framework for the full package, and completion of the package by 1992 (*Reforming World Agricultural Trade* 1988). This would essentially postpone by two years both the "early harvest" envisaged for 1988 and the completion of the final package, but it would maintain the comprehensive outcome sought by the United States and agreed upon by the other Uruguay Round participants from the outset.

Needless to say, full achievement of US goals in the Uruguay Round will require important concessions by the United States, and will not be easy in any event. It would therefore be prudent to continue to explore the possibility of additional bilateral or regional arrangements, both for their potential substantive benefits and to remind other countries that there are alternatives to the multilateral approach if it does not succeed. Given the high payoff from a successful Uruguay Round and the limited scope for substantive bilateral outcomes, however, the policy focus should be on completing the multilateral effort.

DOMESTIC POLITICS

Two related domestic political requirements must be met if the new administration is to implement a trade policy of the kind suggested here, rejecting pressures both for new protection at home and excessive mercantilism abroad. First, the President will have to reassert leadership of American trade policy. He must do so in full consultation with the Congress, but presidential leadership is essential for an effective and sustained trade policy, and, despite occasional signs to the contrary, this leadership is desired by the Congress itself (Destler 1986).

President Reagan and his Treasury Department abdicated trade leadership during their first term by virtually ignoring these issues and by helping to create the massive external deficit with their budget deficits and their "benign neglect" of the exchange rate. This led directly to an upsurge of protectionism (Baker 1987). For the first time in over fifty years, Congress felt compelled to try to fill the leadership vacuum. The result was a virtual stalemate between the two branches, with the administration belatedly seeking to reassert authority after September 1985, but never able to gain the full confidence of the Congress or of key constituency groups. The struggle over the trade bill lasted more than two years, and resulted in over 1000 pages of legislation that will have little impact on the core trade concerns of the United States addressed throughout this

Mr. TURE. Mr. Archer, I do not want to be the maverick here, but I think it should be pointed out that those targets are works of art. They are not scientifically arrived at. I think they have proven to be an extraordinarily useful device, for reasons I have suggested in response to the chairman's question, in disciplining decisionmaking in the Congress, and, for that reason, it seems to me they are entitled to the greatest of respect.

They are stated in nominal terms, and I think that we all ought to be wise enough to realize that it is the budget deficit in real terms, or constant dollar terms, not in nominal terms, that should be the operational number. Let me refer to table 3 in my testimony, which shows that if you take the CBO projections on baseline—no changes in either current programs or authorizations—that in constant dollar terms you get a very substantial reduction in the budget deficit down to $5 billion in fiscal 1994. That $5 billion ought to be treated as even less than a statistical discrepancy.

I would endorse the notion of a device like Gramm-Rudman-Hollings, but I do not think that the specific numbers that you see there, particularly those in nominal terms, are sacrosanct.

Mr. ARCHER. You, Mr. Bergsten, testified as did Dr. Lawrence that there is a direct relationship between the budget deficit and the trade deficit. I know there are many economists who espouse that belief.

But you also said that we have got to take action to get the trade deficit down commensurate with the reduction in the budget deficit, which leads me to believe that there is not a direct connection that occurs automatically.

Maybe I am misreading the nuance of your responses, but if I am correct, what actions, other than getting the budget deficit down, can we take specifically to get the trade deficit down?

I do not want to speak for you, but I understood you to say that what we do in trade legislation is relatively insignificant in its impact on the trade deficit.

So what other things can we, or should we do? Should we do the value-added tax that Dr. Lawrence recommends, or are there any other specifics that you can give us?

Mr. BERGSTEN. Let me put it this way: Reducing the budget deficit is a necessary condition for reducing the trade deficit but it is not a sufficient condition. It is necessary because, at this point, the economy is very close to full employment. Suppose you drove the dollar down 20 percent overnight, and we wake up tomorrow and American industry is 20 percent more competitive. Obviously we would be able to sell more exports, and we would have fewer imports, but we do not have any unutilized resources in the economy to devote to more exports, unless something else is cut back in terms of domestic spending.

We could have a recession, and cut back domestic spending on everything, including imports, and that would free up a lot of resources to improve the trade balance. But we obviously do not want to do that.

My point is that right now we must free up domestic goods that are being produced, to be exported, or else——

Mr. ARCHER. I listened very carefully to your testimony and I understand what you are saying, but I am asking you if there are any other specifics that we can take, by congressional action, to try to get the trade deficit down.

Mr. **Bergsten**. Well, congressional action is tougher in the shortrun. There are a lot of issues relating to the long-run competitiveness of the economy: The merits of our educational system. Are we spending enough on R&D? A whole range of issues of that type with long-run payoffs on which I think the Congress can take constructive action.

I agree with Dr. Lawrence. If you include tax increases as part of the budget package, they certainly ought to be aimed at dampening consumption and promoting private saving. That reduces our dependence on foreign capital and permits us to have a better trade balance.

The other major step, though, beyond the budget deficit, that is really needed to get the trade deficit down, is probably some further decline in the exchange rate of the dollar.

There is a mythology around, to add to the ones that Dr. Lawrence cited, which says the decline of the dollar hasn't helped U.S. trade. Well, that is nonsense. When the trade deficit was at its peak 3 years ago, we were headed toward trade deficits well over $200 billion. Some analyses say $300 to $400 billion. We have brought them down to $100 billion-plus largely through the decline in the exchange rate of the dollar.

However, we have not gone far enough yet, and in conjuction with a budget reduction package another 10 to 15 percent decline of the dollar would increase our price competitiveness to the point where we could then probably come close to eliminating the trade deficit.

There are some things foreign countries have to do to permit this to take place. They have to keep their economic growth rates rising. They have to avoid trade barriers.

I do not want to be misinterpreted on trade policy. I did not say that what the Congress could do, or what trade policy could do was insignificant. I think there are billions of dollars worth of U.S. exports that are being blocked by foreign barriers. Even more broadly, now that U.S price competitiveness is very strong with the lower dollar, if we could take these additional steps I mentioned, we would still need open access to foreign markets and more liberalization of what they do, and I suggested at the end of my statement pushing very hard in that direction.

I think the Congress ought to continue to push that very hard. The trade bill, in some respects, helps toward that goal, but I am not sure you can legislate anything immediately that is going to make a big additional difference in that regard.

Mr. **Archer**. Let me, because time is running out, and in deference to the other members, ask one last question. What is the opinion of each of you on the President's recommended method of trying to get the deficit down with the so-called flexible freeze.

Mr. **Lawrence**. Well, I personally think that it is one way to try to do this on the spending side. I am not convinced, however, that the Congress and the President, together, are going to be able to meet those requirements.

It is a miracle of compound interest, that if you have one line, and call it spending, and it grows at 4 percent, and you have another line, call it revenues, and it grows at 7 percent, eventually those lines will cross.

And essentially the strategy for dealing with the budget deficit is to do that, to allow revenues to rise as fast as GNP and to keep spending fixed in constant terms.

My own sense of looking at the numbers, indeed, along the lines that Chairman Rostenkowski cited earlier, that once you have excluded large proportions of spending from consideration, such as Social Security, such as talking about even just holding the line on defense, and given what is going to come up in Medicare, my own sense is that it is going to be an extremely difficult objective to meet.

And therefore, I personally believe, if not this year or next, ultimately, major revenue increases are going to be required as well.

Mr. TURE. Mr. Archer, I think that the best way to perceive the President's flexible freeze proposal is as a strategy rather than as a specific detailed program for achieving a specific result.

I think that it represents almost an ultimate strategy because, in essence, it says that the aggregate budget outlays should not increase in real terms at all. I do not think you need to go to quite that extreme to accomplish, mightily by way of deficit reduction. The kind of arithmetic that we, at IRET, have done on any number of occasions, suggests that you can bring the deficit down very smartly, indeed, while still having some significant increase in real growth in aggregate outlays.

I want to go back, however, to a point that I offered early on in my testimony. I think the focus on what the numerical difference between revenues and outlays, as a matter of just getting the budget deficit down, really is a misplaced emphasis in budget policy.

It directs your attention, as the chairman has indicated, away from the vastly more important questions of what it is that the Federal Government ought to be doing, and how much of each of those things it should do.

As long as you focus only on the size of the deficit and its path through time, you tend to ignore those considerations. They take second place.

I think it is time to refocus budget policy and give those considerations somewhat greater priority.

Chairman ROSTENKOWSKI. Mr. Rangel will inquire.

Mr. RANGEL. Dr. Ture, and the panel, I want to thank you with my colleagues for being with us.

Mr. Ture, I voted against Gramm-Rudman because, to me, it was an embarrassment for the Congress to say it wanted to automatically cut the budget without having the courage to specifically tell its constituents as to how the programs would be affected.

But it did not cause you any problem at all to testify that you were violently opposed to an increase in taxes, strongly recommended that we have cuts, but that you did not have the vaguest idea as to where these cuts would be. That you had a list somewhere that you would send to us, but you still were locked into a position that the Congress should do the cutting.

And I guess that is what Gramm-Rudman is all about. That if we cannot figure out how we are going to face up to this in a political way, that we just turn it over to the computers. But that does not surprise me, that no one would help us out on this issue. It may be the right thing to do, but, politically, we may not be able to do it because a lot of people believe, as you do, that it is some kind of a public policy not even to discuss tax increases.

And you went as far as to say it. That a proposal to raise taxes, no mater what the nature of the tax increase, would be in direct conflict with the numerous public policy objectives that the Congress has.

Do you know of anything that the Congress has said, or done, that would have you to believe that raising taxes violated some policy that we have?

Mr. TURE. Indeed, yes, Mr. Rangel. My remark is predicated on the view that any tax increase will have deleterious effects with respect to the efficient performance by the market system of its functions, and that it will not increase saving but will reduce it, and therefore impair economic growth and the advance of productivity.

Every part of the Congress, at one time or another, has been on record as saying increasing the rate of advance of productivity, enhancing economic growth, increasing economic efficiency, are public policy objectives.

Most recently—or not most recently, but certainly very importantly, you made that statement in setting up the National Economic Commission. You asked it to come up with recommendations for reducing the budget deficit, and, at the same time, promoting saving, investment, and economic growth.

Mr. RANGEL. Yes, but still, that does not mean that because we all want to reach the same objective, that there is some policy against raising revenue through taxes. That is your opinion, that we should not raise taxes, but it certainly does not violate any policy that I know that we legislated, even though I know a lot of people believe that.

Mr. TURE. You might very well disagree, Mr. Rangel, with my assessment that increasing taxes will have these injurious economic effects.

Mr. RANGEL. Well, let's say that I have been advised by staff. They prepared a booklet for us on February 6, and they have a table here to show that when taxes are the highest, from 70 to 90 percent, that savings were the highest.

And now that we have dramatically reduced the top tax rate in the chart that I have is that savings have gone from the 1950's, at 7.5, as a percentage of the GNP, down to 4.5.

Mr. TURE. I believe that the ratio that the staff report presents to you is a ratio of net saving to gross national product. That is apples and oranges. The appropriate ratio is either net saving to net national income, or gross saving to gross national product. Gross private saving has not fallen. It has ranged between 15 and, roughly, 19 percent of GNP for many years past. It increased early on in this decade and has wavered in the 17 percent range.

I think it is, incidentally, statistically, a much sturdier number to use than the net national saving number.

Mr. RANGEL. Well, let me ask you this: That since the individual tax rate and the corporate rates have plunged in the last few years, and certainly between 70 percent for individuals down to 28, do you have any tables that would show that same dramatic increase in saving as a result of the reduction in taxes?

Mr. TURE. No, and, indeed, the data will not establish that point at all. I think that what one observes is that there is a very quick market response to changes in the relative cost of saving and capital formation, and by virtue of that you get an instant shock which comes about by virtue of tax changes, whether they are increases or decreases. You get a very quick response in terms of either decreases or increases, respectively, in the amount that people save, and that change is very quickly wiped out by virtue of the new adjustments.

Mr. RANGEL. Well, I do not know. The Economic Recovery Tax Act was supposed to have caused a dramatic increase in savings, and improvement in plant and equipment, and we reduced taxes then, and then we reduced the rates with the reform program, and somehow the economists keep saying we should find the savings.

We do not find the savings, and yet, if you even suggest that you might increase taxes, everyone says that that is going to have an adverse effect on savings.

Mr. TURE. I simply cannot think of any kind of tax increase, except in a sort of never-never land, that will induce anybody to save more, and the natural consequence of tax increases is that people will save less.

Mr. RANGEL. I am not saying that on savings, but it might induce us to borrow less and thereby cut down the interest rate if we did increase taxes.

Mr. TURE. I cannot find any connection, statistically, or analytically, between the amount the Federal Government borrows and the level of interest rates, or even the direction of their change.

Mr. RANGEL. Well, I just thought that if you had expenditures, the only way that you could balance or reduce the deficit is by reducing spending or increasing revenue, and I thought if you did decrease the deficit by increasing revenue that you would decrease borrowing.

I thought if you decreased borrowing, it might decrease the interest that you are paying on what you borrow, but then, again, I am not an economist. So I will study your paper a little further.

Mr. TURE. It will certainly decrease the amount of interest you pay, but there is no reason to assume that it will change interest rates.

Mr. RANGEL. That is what I meant to say: the amount of interest that we are paying.

Chairman ROSTENKOWSKI. Mr. Coyne will inquire.

Mr. COYNE. Thank you, Mr. Chairman.

Dr. Bergsten, in response to Congressman Bill Archer, you indicated that the trade deficit would probably be much higher except for the falling dollar. Would you attribute the voluntary restraint agreements in the steel area, and the agreements that was reached relative to automobiles with Japan, as a contributing factor to keeping the trade deficit down, or would you attribute it exclusively to the fall of the dollar?

Mr. BERGSTEN. Well, you have to remember that both of those agreements were reached much earlier: the auto agreement started in 1981, and the steel agreement first came about in the late 1970's and then was revived in 1984. Both were put in place during periods when the trade deficit was still rising sharply. Now, they may have kept it from rising a little bit more than it otherwise would have. Even there one cannot be sure because they probably didn't have much effect on the underlying savings and investment trends in the economy—the macroeconomic forces we talk about.

Those agreements, at best, kept the rise in the deficit from getting worse. Most economists feel that when the deficit started to come down, which was really in 1986 and 1987, the auto restraints had begun to lose their bite, for a variety of reasons endemic to the industry itself. I think most analysts of auto trade feel that the decline in the dollar was the major reason why the Japanese exporters have not even been meeting the full export quota that they are permitted under the restraint agreement now.

Steel is a little more complicated, but on that subject also we have done some analyses at my institute. We have also done studies on textiles, interestingly, which suggest that a very large amount of the change in both directions can be accounted for by the exchange rates. A lot of the deterioration in our trade balance in textiles was clearly due to the stronger dollar. You may not remember, but the United States had a trade surplus in textile trade—not apparel, but textile trade—of several billion dollars in the late 1970's and early 1980's. That converted into a deficit in the first half of the 1980's, and our analysis suggests that was largely because of the high dollar. Now textiles are back close to balance, or to a small surplus again.

So I do think a very large part of those sectoral changes were exchange rate driven, and given the timing of it all, I think it would be hard to give the voluntary restraint agreements much credit for reducing the trade deficit.

Thank you.

Mr. COYNE. Thank you.

Chairman ROSTENKOWSKI. Mr. Brown will inquire.

Mr. BROWN. Thank you, Mr. Chairman.

Dr. Bergsten, some people have speculated that private savings rates are influenced primarily because people are concerned about their childrens' education, about preparing for their retirement, about protecting against some medical emergency. Obviously there are other reasons, but those seem to be the major ones that people use to set something aside for the future—medical emergency, childrens' education, and their own retirement. Those are largely functions we in Government have moved, in recent years, to try and take care of. It is certainly, at least in part—but not totally—and as much as we try to do for the poor.

I guess my question is, do you see any relationship between changes or declines in the savings rates, and Government's efforts to eliminate uncertainty in those areas?

Mr. BERGSTEN. I wish I had a good answer to that, and Dr. Lawrence may have a better one. I would simply observe that most of those changes that you mentioned started to come in much earlier, and in the postwar period the big increases came in the 1960's and early 1970's, during which the private savings rate stayed at about its historical level.

The one thing that is peculiar about the U.S. savings rate, compared with other countries, is that it has been amazingly constant over our national history, as well as we can tell from published data. The U.S. savings rate is about the same now as it was before we had a tax system at all, going back into the 19th century. Saving rates in other countries have bounced around a lot, whereas ours has been amazingly consistent, and it would therefore raise doubts about that kind of an analysis.

Now, one cannot say that there are not long lags, even though improvements in the Government programs you mentioned, such as increased Government supports, came in in the 1960's and 1970's, and possibly didn't have an effect on savings behavior until the 1980's. But I would offer an alternative hypothesis, and challenge what Dr. Ture was saying.

I agree with Mr. Rangel that big budget deficits raise interest rates, and it could be that they perversely reduce savings rather than increase them. There is something called the target savings hypothesis, which says that American savers set a certain goal for their investment income, so that if interest rates rise, they are able to save less and get the same investment income. We know that some institutional investors and savers take that approach explicitly.

Perversely, therefore, rising budget deficits, which reduce savings through higher Government spending, may also reduce private savings by pushing up interest rates. Conversely, if that is true, reducing the budget deficit by taking pressure off interest rates might also increase private savings. The result would be a double barreled gain in terms of the economic goals we have talked about, and I think Mr. Rangel was pointing to.

I don't want to suggest that we have conclusive proof of such behavior, but the evidence from the 1980's supports that thesis, and I would be more inclined to go that way than pick up on the line of argument you are suggesting.

Mr. TURE. May I respond?

What Dr. Bergsten has just suggested is that it would be good public policy to put up a 100 percent marginal tax rate on savings, and people would then save like it was going out of style.

Mr. BERGSTEN. No, I didn't say that.

Mr. TURE. His notion is that the more expensive saving is, the more of it people do, rather than less expensive saving is, the more people do.

Let me be directly responsive to your question, though. I think there are a great many factors that are difficult to enumerate, and to give appropriate weight to, in trying to determine the saving behavior of an economy that is as large and as complex and as dynamic as this one. Demographic factors, such as the age distribution of the population, are among the more obvious ones.

What it costs to save, as opposed to consume currently part of your income, it seems to me, has to be a very powerful influence. What is generally overlooked, when people make observations about the saving behavior in the United States, and propose one or another institutional change, is that mostly people focus on personal saving, rather than on the total saving undertaken in the private sector. And what that does, in effect, is to put a wall between individuals, as people in households, and individuals as investors, and as owners of businesses.

It seems to me that is an artificial distinction to draw. If you look at the aggregate gross private saving behavior in the United States, which, to repeat, I think is the appropriate magnitude to examine, what you will find is that we had, following the recession, a surge in business saving, primarily as a result of the changes in the tax law, that is, the introduction of the accelerated cost recovery system, and the liberalization of the investment tax credit.

Following, a few years later, that rate came down, by virtue, I think, in large part, of restrictions that were subsequently imposed, both on ACRS and on the investment tax credit.

Mr. LAWRENCE. I would like to come in, in my testimony, on Table 1, I present these components of national saving, and what is clear to me is that the number that Mr. Ture has been talking about, our gross national savings, last year stood at 15 percent of GNP, considerably lower than it was in the 1970's. I think we had a wonderful experiment.

Mr. BROWN. Dr. Lawrence, you are saying that it has changed, that it is not consistent?

Mr. LAWRENCE. I think that it has come down. I am saying it is not being offset, there is not an offset now in business savings for this decline in the personal savings rate.

I would say, second, that we have had a wonderful experiment in the 1980's about the response of savings to different kinds of incentives. I would simply like to complement what Mr. Rangel pointed out. We have done several things, which people allege would raise the personal savings rate.

Number 1, we have had tax breaks, IRA's, to encourage saving. Number 2, we have lowered marginal tax rates. Number 3, we have had high real interest rates, and number 4, we have seen an aging in our population. Each of those is supposed to raise the personal savings rate, it has actually declined.

Finally, I would add that some economists believe that if the Government has a big budget deficit, farsighted private citizens will realize eventually there is going to be a tax hike, and they are going to start to increase their savings. That theory hasn't panned out, either.

So that I think that by looking at the evidence of the 1980's, I draw the conclusion that perhaps our private savings rates will pick up at sometime in the future, but the various measures, and the numerous measures that we have taken so far to induce private savings to rise, simply haven't worked.

Mr. TURE. I think what the data for that period actually show is that you have had a very quick response of gross private savings to changes in institutional arrangements, and, as I suggested in my response to Mr. Rangel, that response is temporary, because markets make the appropriate adjustments. We had a very quick run up, and a very substantial run up, in the gross private saving rate following the recession. We have had a decline since then. The decline in the most recent period, I think, can be attributed very largely to the much larger bite taken out of gross business saving by the tax changes enacted in 1986.

Mr. RANGEL [presiding]. The Chair at this time would like to recognize Mr. Moody.

Mr. MOODY. Thank you.

I think it is it has been a very interesting exchange, and I appreciate the level you have brought to it.

Let me ask any of you, when we look at the spending side of the budget, do you consider the payments to interest—debt servicing—as a spending issue? You have been talking about spending, Government spending is going up, going down, whatever. Debt servicing is obviously the most rapidly growing section of the budget, and growing even faster than Medicare and defense.

Is that spending, or is that merely a transfer of resources? It is not actual command over final resources. Isn't it simply a transfer. Could someone elaborate, because we have talked about the command over resources as being at the heart of what we are talking about, particularly under Mr. Bergsten's analysis.

Are interest payments actually command over resources? Do any of you want to comment on that? This is a technical point, but I think it gets to some of what you are discussing.

Mr. TURE. I think the question is extremely trenchant. I appreciate your asking it. Most of the kind of analytic one hears about in the attempt to relate budgetary magnitudes to other phenomena deal with purchases of goods and services on the spending side, not with total spending, and I think in most instances that is the correct concept.

I think you are right on the money. It is not merely interest, incidentally, it is transfer payments generally that do represent a change in the allocation of claims to the output and the income of the society, but do not in themselves represent exhaustion of any of that output.

The distinction is one which, I think, all of us as analysts must keep in mind always. The interest on public debt now represents virtually the entire deficit.

Mr. MOODY. Right. Exactly, that was what I was going to point out, but if you add transfer payments, and Social Security and other programs, and you add interest payments, the actual Government command over fiscal resources, it seems to me, has been shrinking very dramatically.

Dr. Lawrence.

Mr. LAWRENCE. Well, I would say, first, that interest rates are after all a nominal magnitude. Some proportion of that interest rate is to compensate bondholders, because of higher inflation rates.

Mr. MOODY. Sure.

Mr. LAWRENCE. So in a sense that component is a neutral impact.

Mr. MOODY. Right.

Mr. LAWRENCE. It is simply restoring the bondholders for what the erosion——

Mr. MOODY. Anticipated.

Mr. LAWRENCE. At the same time, however, there is a material difference between simply having interest payments, and paying for, financing those interest payments by raising taxes. You can see there that there would be a withdrawal of purchasing power from some citizens, in order to provide it to others.

Mr. MOODY. But the command remains in the private sector in both cases. You take away private consumption by raising taxes, and then you hand it to the bondholders, and that is still private consumption.

Mr. LAWRENCE. Correct. So that you are, in a sense, transferring resources from some citizens to others. Now, in an open economy, in which we live, of course some of those people holding the bonds don't live in the United States.

Mr. MOODY. Right.

Mr. LAWRENCE. So you can have allocational effects across the world economy, in ways that we may be concerned about.

Mr. MOODY. Right.

Mr. LAWRENCE. Even if in the aggregate you could say that this is simply a transfer.

Mr. MOODY. Right.

Any of the other gentlemen?

Mr. ENTIN. Mr. Moody, table 3 in our prepared statement in fact tries to measure the effect that Dr. Lawrence has just mentioned, it takes the inflation rate times the outstanding Federal debt, and shows the degree to which the interest outlays, and indeed the deficit are in a sense overstated by inflation, and that is one of the reasons for feeling that the budget as we measure it is perhaps not the appropriate focus for policy.

Mr. MOODY. Thank you.

Mr. TURE. I think your point, Mr. Moody, though, as I hear it, is very well taken. That is that if one measures the budget in terms of purchases of goods and services, that rate of growth has been quite slow. As a fraction of GNP, it has certainly been falling.

One final observation, if you relate purchases of goods and services to the revenue side of the budget, we run a very substantial surplus.

Mr. MOODY. Right. Well, the reason I brought it up is that Dr. Bergsten's analysis was really one of real resources. I mean, you presented us with a real analysis, rather than a financial analysis of the budget debts, that we are pulling out resources faster than—we are consuming them faster than—we are producing them, and we are borrowing the balance, as you pointed out.

I was just wondering if the transfer elements of the budget alter your analysis at all?

Mr. BERGSTEN. Not really, because my analysis focuses on cash flow and financing problems.

Mr. MOODY. Yes.

Mr. BERGSTEN. I agree that one has to correct for nominal versus real, and make the distinctions you make for some analytical purposes, but at the end of the day you have to finance your imbalance, whether it is the Government imbalance or the national imbalance—the trade deficit—in nominal dollar terms, and borrow that amount. It is well and good to say that as a share of total GNP, or that distributional effect, is declining or changing, the fact remains we have to borrow over $10 billion a month in nominal dollars from the rest of the world, and that is the element that——

Mr. Moody. That does set up paper claims which have command over real resources, eventually.

Mr. Bergsten. That's right. They ultimately do, and to try to mask that by saying that the share of our foreign debt to GNP is declining has some relevance, but it certainly doesn't tell the whole story, and it doesn't, I think, have much effect in the minds of the financial markets.

Put it this way. If the people who were putting in the $10 billion a month had in their minds a command concept, or a real resources concept, they might be much more relaxed about the prospect of having to build up another half trillion of dollar assets over the next few years, but I don't think they do.

Mr. Ture. May I sort of paraphrase what much of this discussion is about?

The statement is that the United States overspends, and the sense of that observation is that our aggregate outlays exceeds our aggregate production. That I think is incontestably true.

What generally follows is the assertion that overspending is a result of the Federal budget deficit. That is incontestably not true. The budget numbers that would be relevant for this purpose are not aggregate outlays versus aggregate revenues, but purchases of goods and services versus aggregate revenues. In that respect we run a surplus.

One cannot tell from simply looking at the national income and product account identities in what respect we overspend, for purposes of determining the fact that we have a trade deficit. What one can say is that as a matter of appropriate public policy we may want to get personal consumption down, although I don't know on what basis that conclusion could be reached. I think very few of us, nobody at this panel, would want to get private investment down, which leaves us with the question of do we want to reduce Federal purchases of goods and services. And I think there is a dispute clearly on that matter.

Mr. Moody. Any one else? My time has expired, but I don't want to cut anybody off.

Mr. Bergsten. I would like to come back to that, just quickly, to say that whether one's accounting method places the Government budget in surplus or deficit, the issue is what has changed over the course of the 1980's.

What I suggested was that an enormous increase in Government spending, both gross and net, has been added to reasonably normal levels of private spending, and that is what causes us to run a trade deficit and to require foreign capital inflow.

The policy question is, where do we cut back to bring domestic spending within the capacity of domestic resources? I agree with Dr. Ture, I don't want to cut private investment, I would like to see more private investment. But then your choice is essentially private consumption or the Government accounts, and I would prefer, in the first instance, to go after the Government accounts.

However, remember that some cutbacks, Government programs, and transfers, and increases in taxes, would show up in the national product accounts, show up as a decline in private consumption—private consumer spending—and that would have to be part of the adjustment, there is no other way to get to the outcome that I would want.

Mr. Lawrence. I find it interesting that Dr. Ture felt that Social Security, in a sense, should be treated differently, analytically, because of this transfer aspect in his answer to Mr. Moody, and yet he was very strongly opposed to the idea of excluding Social Security from any measure of the Government budget deficit

He also mentioned, earlier in his testimony, that it would be more appropriate to think about the budget deficit on an accrual basis, than it would on a current spending basis. I agree with his statement, and I think that is precisely why we should remove Social Security from the budget, because that and other retirement funds should be kept sound on an accrual basis, so that we ensure that we build up surpluses, as we indeed have now legislated to so do in the Social Security system, that we ensure that we build up surpluses in those funds, isolate them from the rest of the budget, and therefore aim our national savings goals at objectives for the Federal Government, which exclude the Social Security and other similar retirement funds from the budget.

Mr. Ture. I think that is confusion compounded. Isolating and doing what Dr. Lawrence suggested to the Social Security fund means that he is proposing impoundment of the annual surpluses.

Mr. Moody. Sterilization, maybe?

Mr. Ture. Well, he wants to reduce the money stock. That is what that boils down to. Now, the Fed could obviously come back and undo that reduction, but this is an absurdity.

My observation about not excluding Social Security from the budget calculation is because what one wants for budget policy purposes is not only to measure the amount of purchases and goods and services, which is a useful magnitude for some purposes, but also to see what it is that you are doing in the transfer payment area.

If you are going to exclude Social Security from budget accounts, then exclude all transfer payments. That is only logical consistency. You would then have a budget policy that consisted only of looking at revenues against actual purchases by one or another Federal agency, of goods and services. If that would not be misfocusing your attention on what are major budget parameters, I don't know what would be.

Mr. Lawrence. I was not suggesting that.

Mr. Rangel. Mr. Andrews.

Mr. Andrews. Let's go back for a moment to the early part of your testimony and talk about capital inflow for a second. We have gotten away from that a little bit, and I think your comments early on are extremely critical to us.

We have had 3 days of hearings on what we should do about leveraged buyouts. Over the weekend, at the Greenbrier, the Democratic Caucus received a paper by Robert Reich of Harvard, where he suggested in addition to capping interest deductions, that we should impose some form of tariff on foreign investors that attempted to participate in LBO's, or other major investments.

I am curious what your thoughts are as a committee, I don't agree with that proposal, but I am curious as to what your thoughts are about what foreign investment means to our economy, and in particular LBO's. As we try to make policy as a committee, what should we be cautious about in terms of moving forward?

Mr. LAWRENCE. Well, I would like to say that I think that is a very, very bad idea. Recall, that at the moment the United States is involved in some rather intricate negotiations around the world. In particular, we are asking the Europeans to provide our companies with national treatment as they move to 1992.

We are also seeking, in the GATT negotiations, national treatment for American firms. To turn around now, in the United States, and to impose a tariff on foreign investment, that is to discriminate against foreign investors, would be to undermine our negotiating positions all around the world, and so that is why I think it would be a great error.

I think that this Congress has to be very mindful, when it now takes measures, particularly on the foreign investment issue, that there are very sensitive negotiations going on elsewhere in the world, and to act in a way to discriminate against foreign firms in this country, would be to severely impair those negotiations.

Well, Secretary Brady also——

Mr. ANDREWS. If I could, I want to get to Secretary Brady's suggestion that we deal on the interest side. Now, what kind of synergy does that cause with our foreign competition?

Mr. BERGSTEN. It is well known that if we were to limit the interest deductibility of LBO financing, it would give a discriminatory advantage to foreign investors coming in.

Perhaps Reich was suggesting some kind of equalization tariff to offset that. But there I would agree with Dr. Lawrence, and I would go one step further.

As I indicated in my testimony, I think it is extremely dangerous for the United States that we have made ourselves dependent upon foreign capital, because it can dry up at any moment and send our economy into a tailspin. But we are in that position. We require that foreign capital, and we are going to continue for some years to do so.

In that circumstance, to put a tariff on the very foreign capital that we need would be the height of shooting ourselves, not just in the foot, but in the heart. Not only would it deter the type of capital we put the tariff on, but it would, in essence, discourage all types of foreign investors, because then they would say, "Well, maybe my type gets the tariff next."

If we are going to depend on capital inflows, I would rather see it enter as foreign direct investment, the kind that goes into plant and equipment and creates jobs, than into portfolio investment. Direct investment is not going to go back out overnight. T-bills, bank deposits, and positions in equitys and debt instruments can be reversed overnight, and that would bring about the landing I fear. Therefore, given the situation that we are in, I think it would be insane to put restraints of that type on foreign investments.

Mr. ANDREWS. What would be your observation, if we dealt with the interest deduction side? What does that do to our ability to compete? If we try to chill LBO's, and we do it by just dealing on the interest side, not dealing with the dividend side, just on the interest side——

Mr. **Ture**. You may recall, Mr. Andrews, that in my testimony last week I urged very strongly against doing that. I think that you ought to recognize that limiting the deduction on interest is bound to raise the cost of capital. It would have an adverse effect on investment behavior in this country.

I think that Reich's recommendation is wrong on both scores. Certainly I think we ought to have the freest possible movement of capital, as well as any of other kind of resource, across national boundaries.

I second the concluding remarks of Dr. Bergsten, in his initial presentation: good public policy calls for the freest possible trade, with the least possible restriction, not just on the movement of goods and services, but on the movement of production resources as well.

Mr. **Andrews**. Dr. Lawrence, would you concur with that?

Mr. **Lawrence**. Yes.

Mr. **Andrews**. Thank you.

Mr. **Rangel**. The Chair recognizes Mr. Chandler.

Mr. **Chandler**. Thank you, Mr. Chairman.

I would like to return to the question of Social Security and the method for accounting for it, if we may. As you all well know, the Federal Accounting Standards Board, is scheduled to report soon regarding the liability represented by retiree health promises made to companies' employees. Ultimately, there will be a requirement for reporting accurately what that liability is, and obviously what that means to the value of the companies involved.

We know that the book value of companies may very well not look so good. Some may be technically bankrupt, after this accounting for this future liability, is taken into account.

Nothing has really changed. That liability is there today. The fact is, all we would do is report it, and it would all of a sudden become public. It is like having a dark room, you turn the light on, and you can see what is there.

It seems to me that the same thing exists with Social Security. It doesn't make a bit of difference how you account for it, ultimately the liability, especially early in the 21st century, is going to be enormous.

Now, correct me if I am wrong, and—this is a question, not a statement—but aren't we failing to invest, or save toward covering that liability by lending Social Security and other trust funds, to the Treasury for the purpose of offsetting the deficit, regardless of how you account for it?

Mr. **Ture**. Take Social Security off budget, leave it on, as long as the investment is in Treasury bills, there has been no savings. By the year 2015, when you begin to draw down on this so-called balance, it will be a shock to the American people who are in high school and elementary school today to find that there isn't any money there.

Question: Does paying more taxes on payrolls than paying out to beneficiaries—that is the current Social Security trust fund surplus—does that represent the acquisition of real agencies of production that will produce future income stream? The answer is clearly no. What it represents is an excise on the use of labor services, which means that output is going to be less than it otherwise would be.

Mr. Entin, my associate—I think I can say this without fear of contradiction—is one of the Nation's outstanding experts on Social Security. And if I may, I would ask him to elaborate on the reply.

Mr. ENTIN. Mr. Chandler, I had the pleasure, I guess, of working on the Social Security trustees reports for the last 8 years at the Treasury before I went to the private sector. We have recently begun reporting very large trust fund buildups, which has caused some stir, but that is primarily because we started reporting in terms of dollars for the first time a few years ago. Some people have begun to take notice.

The question really is what are you going to do as an alternative. Suppose for just one moment that a portion of the payroll tax were not there, and that the income tax were somewhat higher; you would have a shift in the apparent accounting.

Mr. CHANDLER. Right.

Mr. ENTIN. But it would not change anything real. You are still dealing with the basic Government acquisition of goods and services, its basic total deficit, and its basic impact on the credit market.

Sometimes we were faced with the suggestion that we should put Social Security aside and somehow ratify its surpluses by balancing the rest of the budget and not using the payroll tax revenues for other spending. But the question is: What is the alternative?

If the trust funds were not put in Federal securities but were put in private securities, the Treasury would have to borrow more, and there would be fewer private lenders buying the private securities. You would be playing musical chairs with securities. You would have different ownership back and forth. You would not increase capital formation. You would not increase national saving. You would not do anything other than change the names on the various pieces of paper. So the alternative is not readily apparent, and, of course, by law, the funds are put where they are so that the Secretary of the Treasury does not have to make decisions that would affect investment in the private sector and reallocate resources, which is not the Government's function.

We should not try to socialize the savings function in the economy. The great concern we have about putting Social Security off budget for Gramm-Rudman purposes is that the tendency would be to make the deficit look larger than it really is, leading to tax increases which would fall on labor and capital, slow the growth of the capacity of the economy, and make Social Security harder to service.

The idea that a tax increase raises national saving is based on an assumption which the literature does not support. The assumption is that it comes mostly out of private consumption. In fact, tax increases, at least in the short term—and there is a study on this recently out of Treasury—come primarily out of private savings so that national saving is not improved. That is our concern about putting Social Security off in the corner and forgetting about it.

Mr. LAWRENCE. I would just like to say that I disagree with the viewpoint just expressed.

It seems to me that if the Social Security fund generates a significant surplus and it is simply used to finance a budget deficit, those resources will not, in effect, be saved by the economy. Our capital stock in this economy will be smaller than if we were to aim at a more substantial Government budget surplus in the aggregate by removing the Social Security fund. Automatically, in that latter case, we would find a higher rate of national savings, a higher rate of national investment, and, therefore, workers in the year 2010 would have a higher capital stock with which to work in order to— they would earn higher wages and then would be able to more adequately meet the demands of the Social Security taxes which they will have to pay at that time.

Mr. CHANDLER. Thank you.

Mr. RANGEL. Mr. Levin.

Mr. LEVIN. Dr. Ture, on page 2 of the summary, you suggest revision of the congressional budget procedure to require the Congress to set revenue targets for the fiscal year before taking up spending authorizations.

Let me just ask you briefly, because I did want to ask a question of all three or four of you. How does a government set targets for revenues without determining needs?

Mr. TURE. What I am trying to do with this suggestion is to urge that something that roughly simulates the kind of constraint that all of us——

Mr. LEVIN. I understand that, but do not fall back on the household for a minute. I am asking about the U.S. Government.

Mr. TURE. Yes.

Mr. LEVIN. We have changes in needs. There is an AIDS epidemic; SDI, whether one agrees with it or not, there are new initiatives; there is a scourge of drugs.

Now, how do we set revenue targets before we understand needs? How do we do that?

Mr. TURE. You do not want me to allude to the household sector.

Mr. LEVIN. No, no. Just tell me how we do that.

Mr. TURE. If I may, the analogy is perfect. How does the household determine what it needs by way of resources? It does not have the option of saying, as the Government does, "We can tax some more." It can borrow, but only if it can service the debt and give confidence to the lender that it can do that. The Government does not have that problem to the same extent, as I am sure you are aware.

It seems to me what the Government must do is to say: What change in revenues, discretionary changes in revenues, are tolerable in terms of their economic effects? And only after this committee and your sister committee in the other chamber and your respective chambers would agree about what is an appropriate revenue target should decisions about how much to spend be made. Otherwise, notice what you are saying. You are saying that the Government's draw on the resources of the economy, the Government's ability to alter claims on the resources of the economy through transfer payments, should, in effect, be unlimited.

Mr. LEVIN. No, no, we are not saying that at all. What we are saying is you do them concurrently, and you balance these various factors.

All right. You have been——

Mr. BERGSTEN. Could I just observe that Mr. Ture's analogy is very misplaced. If an individual wants to spend more, he can work harder and earn more. He does not have a revenue ceiling. The concept of a revenue ceiling is very un-American.

Mr. TURE. Let me respond to that. The revenue ceiling the individual has is being able to work more to produce more of something or other that other people value enough to pay for. That is not the kind of constraint that operates in the public sector, regrettably.

Mr. BERGSTEN. Wait a minute. If the Congress votes for an increased spending program, in some sense that is the American public voting for increased outlays. It is analogous with the individual deciding he wants to spend more, and therefore he will go out and increase his revenue. This idea of a revenue ceiling is very peculiar.

Mr. TURE. Provided the American public really felt that it was going to pay for the incremental spending. That is a point that I have tried to make in the body of my testimony; to wit, that what we have now is a tax system that largely divorces spending decisions from the body politic sense of what cost it must bear.

Mr. LEVIN. Whatever side of the aisle we are on, I just think that view is untenable. If you think we just sit here without any reflection on what our constituents want, join us some day.

Let me just ask you all quickly a question. There has been a strange inversion these last years. Dr. Ture is kind of the fiscal radical, and the two of you are the fiscal conservatives. On Social Security, your answers are very clear. Two of you say we have to set aside the money and worry today where we are going to get it 30 years from now, and Dr. Ture says quite the opposite. We have only about a minute.

What is the reason for this inversion? Why do you think the budget deficit is such a major issue? And, Dr. Ture, why do you and your colleagues with whom you associate ideologically try to downplay it? What has happened here?

Mr. LAWRENCE. I think what has happened, from the standpoint of so-called liberal economists, is that the question of stabilizing the economy has become less important. The concern about budget deficits from the standpoint of economic stabilization was always that if you reduce the Government budget deficit, there would not be enough demand in the economy.

I think what we have seen over time, in fact, is that we have been able to keep our economy on a reasonable keel, and that monetary policy has been able to play a major role in that regard. But, today, the concern that I have is much more towards the national savings rate and what the Government can do about raising the national savings rate, because I am concerned about the future of the economy.

So I think that is why you find a shift, coincidentally, perhaps, among people who used to worry about economic stabilization and, therefore, would have been concerned at various times about cutting the budget deficit. Those people now are more concerned about national savings. Therefore, they are emphasizing the importance of reducing that budget deficit.

Mr. **Bergsten**. My answer is simple: that the radical policies of Dr. Ture and his colleagues have turned me into a conservative. They have converted the United States into the world's biggest debtor country. They have made us vulnerable to these possible collapses of foreign confidence. We saw it in 1987. We can see it happen again at any moment. If one is worried about the future of the economy, one better worry about getting back out of that. And I think, with all due credit to their political success, their policies have had a lot to do with that.

Mr. **Ture**. Let me eschew labels. I do not think my views are radical. I think they stem from, and you can find the source of them in, the works of the great English economist, Alfred Marshall, who was not known at the time nor is he known now as a radical, but as an extremely conservative chap.

Let me point out, also, that my friends on the right here are Johnny-come-latelys when it comes to the concern about public policies and national saving. That is a theme that I have been pushing often in testimony to this committee, since the late 1960's.

I do not view my position as radical at all. I would simply say that I do not think that it is the deficit per se that is the operational budgetary magnitude. It is the amount the Government spends and how it spends, and it is the amount the Government taxes and how it taxes, that are the relevant fiscal variables. And if one wants to understand the impact of what Government does on the American economy, one should not look at the deficit per se, which has virtually no explanatory value, but look at what the Government spends money on and how much and how it collects its taxes.

Mr. **Rangel**. Mr. Sundquist.

Mr. **Sundquist**. Thank you, Mr. Chairman.

Dr. Bergsten, is it your view that the role of Congress is to do and spend what the people want, and then we have to figure out how to pay for it?

Mr. **Bergsten**. No. I think you have got a simultaneous equation. You have to solve the two sides of the budget simultaneously. Probably like every other spending body or individual, you would like to spend more than you can finance, but you have not done a very good job of financing what we are now spending, you or the executive branch either. And so I think revenues and expenditures have to be determined simultaneously, but I would go at them together rather than putting one artificially in front of the other.

Mr. **Sundquist**. You said we have not done a good job of paying for what we have spent. Does that get back to what I said earlier?

Mr. **Bergsten**. If you could spend less, I would be very happy with that outcome. But I am afraid the revealed outcome of the last few years is that, whereas you have cut the growth of spending, by cutting some individual programs, I just do not foresee any huge further declines in spending. But I think it is necessary to cut the budget deficit. I think waiting for the two lines that Dr. Lawrence described to cross at some point out in the future—and I think it is much further than 4 years out—is simply too risky for the future of the economy.

Mr. **Sundquist**. I agree with that.

Mr. Ture, in your testimony, one sentence is, "If spending growth cannot be effectively limited, it is extremely unlikely that tax increases will, in fact, be applied to reducing the budget deficit. It is far more likely that additional tax revenues will be used to finance additional Federal outlays."

We had testimony yesterday, I think, from Dr. Miller, who said that if we look historically, that when we raise taxes we traditionally spend more; when we cut spending, then the deficit seems to go down. Are you in agreement with Mr. Miller? And, historically, can you trace that and quantify it?

Mr. TURE. I am substantially in agreement with him. I have seen that kind of tracing and quantification done in a number of papers. I have not tried to do it myself. If they have not been provided to you, I will be happy to have them provided for the record.

[The following was subsequently received:]

Reply by Dr. Ture to Mr. Sundquist's Request for a List of Studies on the Link Between Taxes and Spending

Specific dollar increases in outlays per dollar of increased revenue are found in:

Reagan, Ronald, "Radio Address to the Nation." October 24, 1987, The White House, Office of the Press Secretary.

Vedder, Richard, Lowell Gallaway and Christopher Frenze, "Federal Tax Increases and the Budget Deficit, 1947-1986, Some Empirical Evidence." Joint Economic Committee, U.S. Congress.

A critique of the Vedder, et al, study is contained in "The Relationship Between Federal Taxes and Spending: An Examination of Recent Research." Congressional Budget Office, Tax Analysis Division, July, 1987.

Studies from the academic world include:

Anderson, William, Myles S. Wallace and John T. Warner, "Government Spending and Taxation: What Causes What?" Southern Economic Journal, Vol. 52, No. 3, January, 1986.

Blackley, Paul R., "Causality Between Revenues and Expenditures and the Size of the Federal Budget." Public Finance Quarterly, Vol.14, No. 2, April, 1986.

Holtz-Eakin, Douglas, Whitney Newey and Harvey Rosen, "The Revenues-Expenditures Nexus: Evidence from Local Government Data." Working Paper No. 2180, National Bureau of Economic Research, March, 1987.

Manage, Neela, and Michael L. Marlow, "The Causal Relationship between Federal Expenditures and Receipts." Southern Economic Journal, vol. 52, No. 3, January, 1986.

Marlow, Michael L., "Tax and Spend Hypothesis: Empirical Evidence and Implications." Unpublished paper, 1988.

Marlow, Michael L., and Neela Manage, "Expenditure and receipts: Testing for causality in state and local government finances." Public Choice 53, 1987.

Marlow, Michael L., and William Orzechowski, "Controlling Leviathan through tax reduction." Public Choice 58, 1988.

von Furstenberg, George M., R. Jeffery Green and Jin-Ho Jeong, "Tax and Spend, or Spend and Tax?" The Review of Economics and Statistics, Vol. LXVIII, No. 2, May, 1986.

Mr. **Sundquist**. I would like to ask the panel, if I could, if we cannot arrive at some consensus this year between the executive and legislative branch, and Gramm-Rudman sequestration takes effect, what will the effect of that be, both in our budgeting process in the future in terms of the financial markets and the mindset of people? Would anybody like to comment on that?

Mr. **Bergsten**. Well, as always, the question is, compared with what? In my testimony, I suggested that reliance on sequestration would risk major turbulence in the financial markets, because along the way it implies a breakdown in the effort to negotiate an outcome. That would be taken in many quarters as paralysis of the U.S. governmental process, which in some broad sense might be more important than not meeting the Gramm-Rudman target for fiscal 1990.

If that happens, then I think you have to go ahead with sequestration to at least restore a modicum of confidence. That would be better than to waive the targets, as you did in 1987. I think it is, however, much less desirable than getting on a steady, negotiated path with the administration, and putting it into place in a much more concerted and sensible way.

Mr. **Sundquist**. I would agree with that. But failing that, it would seem to me—and I would disagree with you in this regard—that we would send a message that there is a backstop and the system does work. And is it not possible that the financial community might react positively, knowing that sequestration will occur?

Mr. **Bergsten**. Well, I think when it did occur that it would have that effect. But if the paralysis occurred and everybody agreed to rely on sequestration, a new factor would arise. There would be a lot of doubts that you would really let sequestration happen. You did not in 1987. You are zero for one. There would be a lot of doubt that sequestration would actually happen. I think you would then have to let it happen to restore confidence, and when it did, you would have some of that effect. But you would have gone a long way down a negative road before you got to that point.

Mr. **Sundquist**. Anybody else like to comment on that?

Mr. **Entin**. I question whether the financial community around the world has that much faith in the budget process after all these years of the continuing resolutions and amendments to continuing resolutions.

I would just make an observation that, under sequestration, the budget deficit would be cut more than by a negotiated settlement because we would not have the $10 billion leeway the law allows in meeting the targets by normal procedures. Now, I do not think that would happen to matter, but if deficits matter that much, maybe the world would prefer sequestration. I do not think it is a responsible way to legislate.

Mr. **Sundquist**. I agree. Dr. Ture?

Mr. **Ture**. I would second that remark. By all odds, sequestration takes out of your hands the decisions about what is better than what, by way of what Government should do. It is like you throw up your hands in horror and say, "We do not know how to handle this."

I am not worried about adverse effects on financial markets of such a contingency. And I find it sort of interesting that people say on the one hand that the adverse effect on the financial market comes from the deficit per se; but if sequestration were to reduce that deficit more than otherwise, that would affect the financial market. I do not think you can have it both ways.

But, by all odds, if one can do something to get the budget process on a smoother, more deliberate, much more rational track that it has been for several years past, that would be an enormous plus. I urge you to use your best efforts, and I will help all I know how.

Mr. SUNDQUIST. Thank you, Mr. Chairman.

Mr. RANGEL. Mr. Anthony.

Mr. ANTHONY. Thank you, Mr. Chairman, and welcome to the panel.

I think the record should be made clear that no one in the Congress is talking about allowing Gramm-Rudman-Hollings sequestration. We all think that we should vote and make those hard choices. Unfortunately, it has been printed by the news media that Mr. Darman, who heads up the OMB, as a major spokesman for the Bush administration, has stated publicly that the administration is willing, from a policy standpoint, to take sequestration. So if there is to be any criticism from a policy standpoint, I hope you will direct it at OMB and not at the Congress.

I have got two specific questions, one to Dr. Bergsten. You state that we should encourage foreign investment in plant and equipment because it is more permanent, less likely to flee, in order to protect the inflow of foreign capital that we need to finance our debt, versus T-bills, junk bonds, Government bonds, et cetera. I just wonder if you have any suggestions to offer in terms of how we may modify existing law to encourage that.

Mr. BERGSTEN. I think the thing to do is not modify existing law. Under the existing legal framework, the environment is pretty free. Foreign investors feel reasonably confident coming into the United States with their investments. I think the risk would be if legislation was modified in a way that would impinge on the freedom that investors now have. There have been some proposals in that direction, as you know; one was mentioned before. I think those would be mistakes.

I do not think you have to do anything positive at this point in terms of legislation. The framework is OK; just do not tinker with it. It ain't broke, so don't fix it.

Mr. ANTHONY. So you would suggest, then, more through our talking and trade missions, encourage the permanent investment just simply by whatever marketing tools we have available to encourage them to come and put those plant and equipment in place.

Mr. BERGSTEN. Right. Make clear that we are open to investment, that we welcome it, we think it is beneficial, and avoid any possible perceptions that we were gearing up to put some restrictions on it. I think that would really be the key.

Mr. ANTHONY. And I take it by your head shake, Dr. Ture, you agree with that.

Mr. TURE. It is always a pleasure to find something that Dr. Bergsten says that I can agree with, and I do agree with that.

I would also point out that we tend to pick up on the dramatic pieces of news. It is much more dramatic to see foreigners buying junk bonds than to do the arduous task of finding out what they are investing in in real terms. But that is an important part of the American scene over the last several years. We should not neglect it. A lot of that very kind of investment that Dr. Bergsten is talking about——

Mr. ANTHONY. Since both of you agree, would you agree or disagree that a proposal like the one Congressman Bryant from Texas proposed last year—the Senate did not take it up—that would to collect data to determine the location of foreign ownership would have a chilling effect upon foreign investment?

Mr. BERGSTEN. I am not sure that amendment in the form that was finally worked out would have a very significant chilling effect. I do not happen to think it was necessary, because I think we have most of those data already. But it could be read as a start of a trend that was moving in the negative direction that I warned against. Unless there was some compelling reason to do it, I think I would avoid it.

Mr. ANTHONY. I see again by body action, Dr. Ture shakes his head, and he agrees with you. See, that is what people watching on C-Span miss because they just see one witness at a time. They miss all this interplay.

Mr. Lawrence makes a statement, and these two people over here about shake their heads off. And then you all make a statement, and you all about shake your heads off. So we are confused here watching this body language and the conversation and the testimony. It has made it more interesting, though. I must admit that. It has kept me awake.

Mr. Ture, you made a statement that taxes were only important in terms of how Government taxes.

Mr. TURE. Oh, I did not mean to say that. I hope I did not make that statement.

Mr. ANTHONY. Well, I wrote down the phrase that what was important was how Government taxes.

Mr. TURE. And how much.

Mr. ANTHONY. And how much. Which leads me to my final question: In Ronald Reagan's budget that he submitted to the Congress—and we will find out whether President Bush endorses it or rejects it—a third of the solution to achieve the Gramm-Rudman-Hollings target was by revenue, some asset sales, a multitude of user fees, and some just outright taxes in terms of bringing those that are not part of the Medicare component of Social Security into the system, versus others that have already introduced pieces of legislation that would tax only those people who make over $100,000. And I am sure there will be a multitude of other proposals.

As an economist, what can you tell the tax-writing committee which would be the best way to go, if we have to go in one of those directions?

Mr. TURE. Let's see. I think the first item you mentioned was asset sales.

Mr. ANTHONY. Under the accounting procedures, Gramm-Rudman-Hollings does not give credit for it, as I understand it, but it still would be revenue.

Mr. TURE. I have no objection to asset sales by the Federal Government in the abstract. The notion that this is a way of increasing the revenue flow to the Federal Government strikes me as absurd, conceptually. When the Federal Government sells a building, it is giving up one asset to acquire another.

Mr. ANTHONY. Let the record note that Dr. Bergsten and Dr. Lawrence are shaking their heads yes.

Mr. BERGSTEN. Harmony breaks out on this panel.

Mr. MOODY. Would the gentleman yield for one second?

Mr. ANTHONY. Yes, I will yield.

Mr. MOODY. Isn't it even more true when the Government sells a portfolio, which is what the administration has usually suggested for asset sales, it merely exchanges one revenue flow for another? I mean, it gives away revenues that were going to be coming in, in which case it has the precise same economic and accounting effects as selling a piece of paper called a Government bond.

Mr. TURE. If the committee wanted to find the revenue, the real conceptually correct revenue component in asset sales, it would have to find out something you cannot with current budget accounting: how much of a capital gain, if any, the Federal Government would realize in selling whatever it sells. Since you do not have in budget accounts anything that represents the Government's basis in an asset, finding its capital gain will be very difficult, indeed.

That would be reasonable to look for, but I do not know where you are going to find it.

Mr. ANTHONY. Mr. Chairman, with your permission, I would just like to ask a question, not to be answered verbally, but if they would, submit it for the record.

There are published reports today that tonight President Bush will recommend as a revenue raiser, a reduction in the capital gains rate. It is very controversial. It appears, then, that that will be a specific legislative proposal that will come forward to this committee in order to help pay for some of his other tax credits which cost money, for child care, for some of the other programs that he proposed during the course of his campaign.

If you could, please, submit us your analysis as to whether or not the capital gains reduction would be revenue positive or revenue neutral or a loss. I think it would help this committee a great deal.

[The information follows:]

Reply by Dr. Ture to Mr. Anthony's Request for Views on the Revenue Effects of Reducing the Capital Gains Tax Rate

The revenue effects of reducing the tax rate on realized capital gains depends on three sets of responses: the transaction response, the market's valuation response, and the capital formation response. The first two of these responses, in combination with the rate reduction, primarily determine the short-term revenue effect; the third is the principal element in the long-term effect, likely to be larger and more permanent in magnitude than the others. It should be emphasized that none of these effects is correctly measured by the year-over-year change in tax revenues attributable to the tax on capital gains. Instead, the correct measure of the revenue effect is the difference between the tax revenues that would be obtained in any given period of time if the tax rate is reduced minus the tax revenue that would be obtained in that same time period if the tax rate remains unchanged.

The first response, the so-called "transaction" response, occurs ostensibly because the tax cost of realizing a capital gain is reduced by the tax rate reduction. A variety of factors enter into the decision to sell a given capital asset; virtually all of these are affected by the tax that will be imposed on any gain realized on the sale, hence the reduction in the amount of the sales proceeds. The lower is the rate of tax on any such gains, the less is the constraint imposed by the tax on gain realization. The transaction response really is the gain realization response.

Most of the efforts to estimate the revenue effects of changes in the capital gains tax rate have concentrated on this gain realization responsiveness. If this were the principal determinant of the revenue effect of reducing the capital gains tax rate, one would have to assume that the rate cut might well lose revenue, in the short run. Consider the proposal to reduce the top rate of tax on net long-term capital gains from the present level of 28 percent to 15 percent. This is a 46.43 percent reduction in the tax rate. To break even in the first year in which the lower rate would apply, net long-term gain realizations would have to increase by 86.67 percent or by 1.87 time the percentage reduction in tax rate. If the average percentage gain realized on capital asset transactions were unchanged as a result of the tax rate reduction, the revenue break-even condition would require an 86.67 percent increase in sales of capital assets. This is a plausible but not necessarily a likely response. If this were the sole determinant of revenue effect, it would be well not to count on a revenue increase from reducing the capital gains tax rate.

Even if this transactions effect on revenues is positive, it almost certainly represents only a timing shift in revenue from the farther to the nearer future. A qualification to this conclusion must be made, however, for transactions involving that significant portion of gains which are passed on to heirs, and which are extinguished by receiving a stepped-up basis at death. Insofar as these gains are voluntarily realized as a result of the tax rate reduction, the accrued gains are not extinguished, and the realizations and revenues therefrom represent each year a net increase from the levels that would otherwise have occurred.

Furthermore, reducing the capital gains tax rate would immediately raise the market value of all existing capital assets, hence would reduce the revenue loss or increase the revenue gain attributable to the transaction response. The market valuation effect increases the possibility that there may indeed be a gain, even in the short run. The market value of a capital asset is the risk-adjusted present value of the after-tax income produced by the asset. Other things equal, the less the tax that is withdrawn from the income produced by an asset, the greater is the asset's market value. For this reason, reducing the capital gains tax rate would instantly increase the market value of all existing capital assets; it would also result in greater market value than would otherwise prevail for all future capital assets.

Finally, reducing the capital gains tax rate would increase the after-tax return obtainable by investment in qualified assets, hence reduce the cost of capital. The result would be an increase in the amount of capital compared to the amount that would otherwise be accumulated and maintained. Not only would this additional capital itself contribute to a larger volume of total output and income, it would as well increase the productivity of labor, hence the demand for labor services. This, in turn, would result in a higher level of employment at higher wages than would otherwise be the case. The increased levels of output and of capital and labor income would result in expanded tax revenue flows.

It quite likely that the combined effect of these responses to a reduction in the capital gains tax rate would be an increase in tax revenues. Each effect moves in the direction of offsetting the revenue-losing effect of the rate reduction. Each effect, moreover, tends to reinforce the others. If not immediately, at least within a reasonably short period, the rate reduction should generate higher tax revenues, not merely from the taxes on capital gains but from a much wider range of incomes, than would otherwise be obtained.

Quite apart from its effects on tax revenues, reducing the capital gains tax rate would contribute importantly to moderating the income tax bias against saving and capital formation. By reducing tax-induced distortions, cutting the capital gains tax rate would enhance economic efficiency and lead to a higher growth path for the economy.

Mr. RANGEL. Mrs. Johnson.

Mrs. JOHNSON. Thank you, Mr. Chairman. This has been a very interesting panel, and it is always useful for us to see disagreement and spirited discussion, and we appreciate that.

I do want to point out, Dr. Ture, that I agree with you absolutely that we have managed somehow to sever the connection between taxing and spending. And as our Founding Fathers knew, it is only that connection that has the power to control Government actions. And we are seeing in the outpouring of concern about the catastrophic health care bill what happens when citizens can really see the relationship between taxing and spending. Who pays and who gets?

So I think it is very important that you reiterate that issue that we try to examine those relationships and bring them ever more clearly into focus for the public. And as a followup to the preceding member's questions, I think the same needs to be talked about a little bit more thoroughly in terms of foreign investment. In my mind, it makes a big difference whether foreign investment is in real estate or in manufacturing. Because in real estate, you control only property which you cannot take abroad. But in manufacturing, you control R&D, and then you control new product; then you control ideas, and then you do damage to our productive capability.

Would you agree or disagree with that? And if you think that is important, is it important that we know how much more investment is going into ownership of our manufacturing sector?

Mr. TURE. I think the problem that you cite—that is, that possibly we convey to other nations, or businesses in other nations, things that are technological proprietary—that possibility exists. So does it when we export a product that is technologically advanced.

I do not think you can really restrict the flow of knowledge.

Mrs. JOHNSON. Excuse me. I am trying to make a little different point. If you export technology, whether or not you continue to profit from it for a short time or a long time is to some degree a function of the terms under which you export it. But when foreign investors own a manufacturing facility in America, they make the decisions about how much money should go into research and development. They own the patents; they control the development of ideas; they have the power to say: Ah, we have got a new idea, but we are going to produce it abroad.

It in a sense almost decapitates intellectually, which ultimately is the driver of progress, our economy.

I do not want to over-exaggerate this, but if you have the majority of foreign owners, for instance, in any one sector—bearings, or semiconductors, or whatever—you, through that R&D component, and the issue of who owns the ideas and the patents, I think you pose a graver threat to our future in that area through foreign ownership than through foreign ownership of real estate.

Do you agree, or disagree?

Mr. TURE. I do not share your concern, Mrs. Johnson. I think there are two observations to make. One is that our markets are highly competitive. The hazard of any one company, irrespective of its ownership, establishing a monopoly—which is I think what you are really suggesting— with respect to any particular R&D or process, or product, is remote.

Second, the other observation is that in so far as those manufacturing establishments are here, if they become more technologically advanced by virtue of the R&D that the foreign owners decide that firm should undertake, we benefit from it.

And, in essence, what this really boils down to is they are financing the advancement in the technology that equips our workers, and improves our capacity to produce. Money is fungible; so is investment.

I think the kind of concern that perhaps is a little bit more pointed, that you expressed, is that they may not keep it here. They may develop it here and use it only in a foreign jurisdiction. I do not know that that has happened. I do not say that is implausible that it might, but notice, we compete with them in foreign jurisdictions as well.

Mr. BERGSTEN. I again agree with Dr. Ture. I would add two points. One is that our economy also benefits from a great deal of technology inflow from those firms that are investing here. As is well known, a very large share of American patents now come from foreigners, including foreign investors here. That adds to the technological stock of the economy.

I think it is fair to say there would be a potential risk to our security if we were dependent on foreigners for key technologies. I do not think there has really ever been a case demonstrated where such dependence hurt our national security, but it is a conceptual possibility.

Congress, as you well know, added the Exon-Florio amendment to the trade legislation last year to provide a mechanism to defend against exactly such an outcome. Again, I am not sure it was necessary. The Pentagon has extensive regulations for defense contractors and firms on which it relies, to make sure that they will be available if the need arises. But Exon-Florio adds to that armory of Government responses to possible problems, and I would think with full implementation of that statute, you have a mechanism to deal with the problem that you cite.

Mrs. JOHNSON. I do not share your confidence at all, but I do not want to pursue it. I just wanted to get your opinions.

I did want to follow up, though, Mr. Bergsten, on the comment that you made in your summary about trade barriers and exports, and the importance of increasing exports to resolving our economic problems.

I personally fear that unless we are a lot more realistic about our trade problems we will not succeed. You suggest that we should not take protectionist actions because we do not want to set an example that will discourage a lot of the countries we need to sell to, buying our products.

Well, I would maintain that in the underdeveloped nations, or in the developing nations, where we have had a market, and hope to have a bigger market, many of those nations, because of their own debt problems, are going to have to increase exports and decrease imports, and we are only hiding our heads in the sand if we think they are going to be a part of our salvation.

So they should not be part of that consideration of whether we do or do not develop, "protectionist policies." The bigger problem, in my mind, is those markets that are strong to which we do not have the same access that their producers have to our market.

And while you talk about reducing trade barriers, the tough trade barriers are not tariffs, they are the nontariff barriers, and we have proven ourselves to be weak in the area of negotiating access to foreign markets, particularly to Japan's, but also, in many instances, to European and other markets.

And to seek to reduce trade barriers, without being willing to bring in line the kind of bargaining chips that policies that say, look, if you do not let us in you are not going to be in ours, seems to me absolutely unrealistic.

Mr. BERGSTEN. I fully agree with you. I did not elaborate on the point in my statement, but I am very tough, and was when I was a Government official, about responding to any unfair foreign trade practices.

In fact I am very supportive of retaliation. I think we need more retaliation, in part to deter barriers, so I am fully with you on that.

Mrs. JOHNSON. And when you talk about protectionist restraints, you are not——

Mr. BERGSTEN. No.

Mrs. JOHNSON. Retaliation?

Mr. BERGSTEN. I would not call that protectionism.

Mrs. JOHNSON. Thank you.

Mr. BERGSTEN. No.

Mrs. JOHNSON. You would not call retaliatory restrictive actions protectionist?

Mr. BERGSTEN. Against a clearly unjustified, unfair foreign practice, absolutely not. That is, in my view, enforcing the rules of fair and free trade, and I am all for it. That is not protectionism.

Mr. TURE. May I suggest that Mr. Bergsten is getting perilously close to Mr. Darman in definitional problems. When is protectionism not protectionism? If it quacks, walks, and so forth.

Mr. BERGSTEN. On that one we will end on a note of disagreement.

Mrs. JOHNSON. Thank you, Mr. Chairman.

Mr. MOODY [presiding]. Well, we are keeping our witnesses beyond the appointed hour. Let me just leave, not with a question, but with a comment.

It seems to me that when we talked about the composition of spending and how to finance it, that if we agree that public spending is sticky downward—to borrow a phrase out of Keynes' lexicon for wages—if public expenditure is sticky downward—we know darn well it is with entitlements, and so forth—then the real question is how to finance it, and whether taxing is better or borrowing is better, is really the issue of the day, and not should we raise taxes, or should we not, as an ideological proposition.

We had the Chairman of the Federal Reserve here the other day—Dr. Greenspan—simply saying all taxes are bad. The question has to be compared to what?, and compared to borrowing, and that will depend on fiscal policy, and a lot of other variables, it seems to me. That is what I am distilling from what you have said today.

Thank you very much. I want to announce that the committee will resume at 2:30 in this room, and we will continue the deliberations. Thank you.

[Whereupon, at 12:24 p.m., the committee adjourned, to reconvene at 2:30 p.m.]

Chairman Rostenkowski. The committee will come to order.

This afternoon, the committee is pleased to welcome former Congressman Richard Bolling and Minority Leader John Rhodes. We look forward to hearing what you learned gentlemen have to say, and we look forward to learning something as well.

The public opinion of the budget deficit is something that we are all concerned about, and I am sure that we can expect some words of wisdom from our former colleagues. We are always happy to see you in Washington, and always feel very comfortable that we are going to hear straight from the shoulder what our former colleagues have as an opinion about what we are doing up here on Capitol Hill.

I would just like to go back in time a little bit, and take a measurement of the three of us at least. I remember when John Rhodes had a butch haircut and had far less hair on his head. I remember when Dick Bolling had far less hair on his head, too, and I remember when I had a lot more, too. But it is a long time that we have been associated, and I can just say that if you want to leave any of the chemistry that you took with you when you left the House of Representatives, with respect to the elements of courage, we would be glad to try to cover it, and take it back over on the floor of the House of Representatives.

Dick, you know it is always nice to see you. We sometimes did not agree, but, by God, I do not think I ever won against you. And John, on a personal basis, you know, you went into an emeritus status here, and I think that I miss the times that we used to be able to sit around with our other colleagues, and on a bipartisan, nonpartisan basis, sit around and work out the problems that the institution faces and the country faces, and come to the floor with one united effort.

So it is a pleasure for me to see you all back here, and, John, if you would like to begin with your testimony, the committee is ready to receive it.

STATEMENT OF HON. JOHN J. RHODES, COCHAIRMAN, COMMITTEE FOR A RESPONSIBLE FEDERAL BUDGET (FORMER HOUSE MINORITY LEADER), ACCOMPANIED BY CAROL G. COX, PRESIDENT, COMMITTEE FOR A RESPONSIBLE FEDERAL BUDGET

Mr. Rhodes. Mr. Chairman, first, I want to thank you on behalf of my good colleague, Dick Bolling, and myself, for your gracious welcome, and believe me, we reciprocate all of the nice things that you said.

The only thing I do not agree with is your statement that we look younger than you do. I do not think that is true at all, and it makes me feel that maybe you are not working hard enough.

It certainly is great to see my friends here, Mr. Brown of Colorado, and Jake Pickle, my good friend for many years, and Charlie

Rangel. Charlie, I did not contribute to your campaign this time but I will next time. It was just an oversight.

Gentlemen, it is wonderful to be here and to represent the Committee for a Responsible Federal Budget. Everybody says that is an oxymoron, there is no such thing, but we keep believing that there is.

I would like to introduce Mrs. Carol Cox who is the president of the Committee for a Responsible Federal Budget, and I might say also that she is one of the outstanding authorities, in my opinion, on the subject of the Federal budget and what to do about it.

Without her, there probably would not be a Committee for a Responsible Federal Budget, and I think that would be a loss to the country.

Mr. Chairman, I would like to tell you that this committee has done some rather amazing things with some rather amazing results, in the last year.

One thing which we want to bring to your attention is that in our opinion, the American people really do understand that working toward a balanced budget, which is the task of this Congress, is, indeed, very important.

Sometimes people who live within the beltway or work within the beltway feel that that is not so. We have been outside of the beltway. We have been doing some things which I would call taking the temperature of the grassroots and we found that there is a spirit out there which I really had not detected, and which makes me very proud to be an American.

These people out there are prepared to accept a package of difficult choices to balance the budget as long as it is fair.

Now I want to really repeat this, because if you take side by side various measures which you might want to propose to cut expenditures or to raise revenue, then you get lots of dissidence and disagreement.

But if you can put together a package which people think is fair, their innate desire to balance the budget will overcome the fact that they are not going to like part of it. And as long as it is fair to them and fair to everybody else, they buy it.

In this respect the people may be ahead of their political leaders, and I think that they are.

Campaign rhetoric, at every level this year, could lead one to believe that it might be political suicide, even to hint that we could restrain the rates of growth in defense or in Social Security, or Federal expenditures for health care, not to mention the mortal danger involved if a politician should suggest any revenue increase.

Well, we have conducted 12 deficit reduction exercises around the country this year involving over a 1,000 people, about 125 groups of 8 to 10 people each.

On an average, those groups' decisions produced modest surpluses in the Federal budget by fiscal 1993. Almost all groups agreed to restrain the rate of growth in defense, Medicare, Social Security, agricultural price supports, and virtually every area of nondefense discretionary spending, including entitlements.

In fact there are only two sacred cows in the budget this year, as far as our findings are concerned, and they are education and environmental programs. There is very little support for any cuts in either area.

On the revenue side of the budget, the majority of the groups would do these things. First, they would enact a 33 percent top bracket for individual income taxes.

Second, they would raise excise taxes; impose pollution charges; phase out the child and dependent tax credit between $50,000 and $70,000 per year AGI; limit deductions for business meals and entertainment to 50 percent; extend HI coverage to State and local Government employees; and raise energy taxes very substantially indeed.

Except in the Midwest, there appears to be substantial and growing support for some form of broad-based consumption tax.

These are the results of 12 meetings in 11 cities around the country. These meetings were put together by Members of the House and Senate, and they cohosted those meetings in their home districts and States.

Governor Henry Bellman cohosted the Oklahoma City meeting. The Members of Congress, and the Governor, chose the invitees to these meetings. We did not do it. But we did ask them to pick people from various walks of life. So that we had a pretty good cross-section of the American people.

We encouraged the members to include that broad cross-section. Participants completed the exercise in groups of 8 to 10. In other words, we would divide the audience into groups of 8 to 10 people, put each group around a roundtable, and then we would say to them, here, here is the—and I think you all have a copy of it—"Hard Facts and Hard Choices," which our committee put together. This is a collection of possible alternatives on how to cut expenses, and how to enhance revenue.

And we said, all right, you take this; now you balance the budget. And this is exactly what the exercise was all about. Perhaps the most surprising and most heartening result of the project was this. People did not refuse to consider expenditure reductions and/or revenue increases which would affect them directly.

Participants felt strongly that they could not shift the burden of budget balance on to someone else's shoulders.

Just as an example, in Des Moines, Iowa, and in Omaha, Nebraska, the groups came out with the finding that there needed to be a reduction in agriculture support prices.

If anybody had told me a year or 2 years ago that that would have happened, I would have said no way; but they did it. This also happened in Topeka, Kansas.

And people who were retired—and there were quite a few retirees in this—the dialogue would go something like this. The retired person would say: you are talking about cutting Social Security. What do you do about defense?

Well, the man who was interested in defense would say, well, I could cut it a bit. Then what about the farmer over here? Well, you know, if you are going to cut Social Security and defense, why, we can stand a cut, too.

And amazingly, they got together on packages, and I think this is the most important point that we want to make. If you try to cut individually, one, two, three, you will not make it, and you are going to make some real big enemies out there.

But if you put together a package that is fair, I have every reason to believe from our study, that the people of the country will not only take it but they will applaud you for doing it.

Because they really do want to get a balanced budget. They are terribly uneasy about the deficit. They are terribly uneasy about the rise in the national debt and they really want to do something about it, as long as it is fair to everybody.

You each have a copy of the final report on the project, and we would be happy to answer any questions you have about it.

But before we end our opening remarks, let's take a minute to comment on the Social Security trust fund issue.

Late in the summer, and early this fall, we detected a growing concern from the people in the country over the Social Security trust fund issue.

Today, we think it would be hard to overstate the strength of public opinion, even anger, on this issue. People are beginning to understand that the Social Security trust fund surplus reduces the reported budget deficit.

They do not like our spending Social Security trust fund surpluses to pay for non-Social Security functions of Government. Audiences which were more aware of these issues tended to reduce the deficit faster than Gramm-Rudman-Hollings requires.

They seemed to want to end this budget chicanery as soon as possible, and they know full well that this budget surplus really does just go to take care of the expenses of the Government, and that the only way that there could possibly be a real trust fund would be to have a balanced budget.

Because otherwise, under the unified budget system, all it does is go to reduce the deficit. And when you look ahead at what the people of the country, who will be our earners, and later, our beneficiaries in later years, have to think about as far as what will be there for them, there is no answer to it unless you can say I used the money either to produce more money—and that is a pretty tough one to get to—or we used it to buy down the national debt.

That is probably the only way that you can ease the concern people have because you are spending the trust fund surplus on other programs today.

You may ask if people are aware of the Social Security surplus, why they would vote to restrain the rate of growth in Social Security to balance the budget? The answer ties back to the issue of fairness and packages.

In closing, let us say that this has been a very exciting project for all of us. We are going to do it again this year. Naturally, if any of you would like to have it done in your districts, just let us know and we will be happy to cooperate.

People will accept the hard choices necessary to put our fiscal house in order, but only inside the right package, which is a fair package.

Public opinion polls do not ask people about packages, and thus, we think there is a distortion. You have seen these polls, as I have, and they come up with answers which apply only to certain types of either revenue enhancement or cutting of expenses, and if you do that you do not get the right answer.

If you do it with a package I think you do get the right answer, and we hope the committee will find the results of this project as interesting as we do, but most of all, we hope you will find this report helpful.

And I would like now to yield to my good friend and sparring partner of years back, Dick Bolling, for whatever he would like to say.

[The statement of Mr. Rhodes follows:]

Testimony

before the

COMMITTEE ON WAYS AND MEANS

UNITED STATES HOUSE OF REPRESENTATIVES

to be delivered by

Robert N. Giaimo and John J. Rhodes, Co-Chairmen

on behalf of the

Committee for a Responsible Federal Budget*

February 8, 1989

The Committee for a Responsible Federal Budget is a bipartisan nonprofit organization formed to educate the public on the federal budget deficit and on the federal budget process.

The Committee is Co-chaired by Robert N. Giaimo and John J. Rhodes. Roy L. Ash, Thomas L. Ashley, Richard Bolling, Carol G. Cox, James L. Ferguson, Peter M. Flanigan, James R. Jones, Robert D. Kilpatrick, Arthur Levitt, Jr., James Lynn, James T. McIntyre, Jr., W. Henson Moore, Howard Moskof, Edmund S. Muskie, Rudolph G. Penner, Peter G. Peterson, Leland S. Prussia, Alice M. Rivlin, Elmer Staats, David A. Stockman, Robert Strauss, and Paul A. Volcker are on the Board of Directors.

Mr. Chairman, Representative Archer, Members of the Committee, we are Robert N. Giaimo, former Chairman of the House Budget Committee, and John J. Rhodes, former House Minority Leader, and Co-Chairmen of the Committee for a Responsible Federal Budget. With us today is Carol Cox, President of the Committee.

Our Committee believes that the Federal budget deficit is the most important economic problem facing the nation. Moreover, we believe that average Americans understand it is important to move the budget back toward balance -- and that the average citizen will support the hard choices necessary to achieve that goal.

In other words, Mr. Chairman, we believed that the public opinion polls were wrong when they told us: "People want a balanced budget, but they don't want Congress and the President to adopt any of the options that exist to balance the budget. They don't support cutting popular programs; and they don't support revenue increases."

That does not make sense; we have a lot of faith in the good, old-fashioned common sense of the American people, - so we set out to test our feeling that the opinion polls were wrong.

We undertook a project we called "An Exercise in Hard Choices On the Road". For several years, we have used what we call our Exercise in Hard Choices to help explain the options to solve the deficit problem and the budget process to groups here in Washington. This year, we literally took that exercise "on the road."

We are here today to share with you the results of that effort. We conducted twelve exercises in eleven states, and believe it or not: we have some good news to share with you.

The American people understand that reducing the federal budget deficit is very important. Average citizens don't think in terms of economics, balance of trade, or savings rates. They do, however, have a tremendous reservoir of common sense; and common sense tells the American people that our nation simply cannot continue indefinitely to borrow and borrow -- spend and spend.

Average Americans don't like using social security trust fund reserves to pay for other government programs. They have begun to understand how the social security trust fund makes the operating deficit look smaller than it is -- and this makes them angry in a way that deficits in the abstract never did.

People are prepared to accept a package of difficult choices to balance the budget.

In this respect, the people may be ahead of their political leaders.

To listen to the debate here in Washington, one could conclude that it might be political suicide even to hint that we could restrain the rates of growth in defense, or in social security; or federal expenditures for health care -- not to mention the mortal danger involved if a politician should suggest any revenue increase at all.

In every single one of our deficit reduction exercises last year, participants were willing to do all of the above. So long as the package is perceived to be "balanced and fair", people seem willing to accept slower rates of growth in virtually every area of federal spending; they seem willing to accept revenue increases. Indeed people seem to feel that they personally -- and their own sections of the country -- should contribute to this effort.

Members of the House and Senate co-hosted seven of these meetings in their home Districts and States. Governor Henry Bellmon co-hosted the meeting in Oklahoma City. The Senior Citizen's Intern Program in Washington, The Aspen Institutes Associates Program, and two university audiences, complete the list of groups which participated in this project.

The Members of Congress and the Governor chose the invitees to these meetings. We were only minimally involved in the selection of participants. We encouraged the Members to include the broadest possible cross section of their communities, and they did.

Participants completed the exercise in groups of eight to ten. We assigned participants to groups. We tried to ensure that each group represented a cross-section of interests: business, labor, education, retirees, students, community activists, farmers, etc. Each group was told to think of itself as a budget committee.

The project was designed to offer participants choices to balance the federal budget by fiscal year 1993, as the Gramm-Rudman-Hollings Law requires.

On average, the groups' decision produced modest surpluses by Fiscal Year 1993.

Almost all groups voted to restrain the rate of growth in almost every area of federal spending -- and to raise revenues.

Almost all groups agreed to restrain the rate of growth in defense, medicare, social security, agriculture price supports, and virtually every area of non-defense discretionary spending.

If there were two "sacred cows" in the budget, for the groups which completed this exercise, they were education and environmental programs. There was very little support for any cuts in either area.

A majority of groups voted to raise excise taxes, and to raise energy taxes very substantially.

They would impose pollution charges; phase out the child and dependent care tax credit between $50,000 and $70,000 adjusted gross income; limit deductions for business meals and entertainment to 50%; extend HI coverage to state and local government employees.

A majority of the groups would enact an explicit 33% bracket for individual income taxes. That was the only change in income taxes, individual or corporate, which a majority of groups would support. They rejected rate increases, surtaxes, and changes in the alternative minimum tax.

Except in the midwest, there appears to be substantial and growing support for some form of broad-based consumption tax.

Perhaps the most surprising and most heartening result of the project was this:

People looked for expenditure reductions and/or revenue increases which would affect them directly.

Participants felt strongly that they could not shift the burden of budget balance onto someone else's shoulders.

In Sacramento, California, there was wide support for raising excise taxes on beer and wine -- notwithstanding the fact that the economy in that area depends heavily on the wine industry.

In Phoenix, Arizona, cotton farmers were willing to increase fees for federal reclamation water -- notwithstanding the fact that they need reclamation water to keep their industry alive.

Throughout the farm belt, groups voted to cut agricultural price supports, understanding that farm communities (not just farmers) would be affected by those cuts.

People also recognize that they must make trade-offs. Time and again, we heard the following exchange:

Defense advocate asks: what are you willing to do about social security?

Retiree responds: what are you willing to do on defense and taxes?

Someone chimes in: why don't we see if we can do something in every part of the budget?

And they DID -- that is exactly how the vast majority of the groups in this project reconciled their differences.

Defense "Burdensharing"

We included "burdensharing" options in the exercise by popular demand. In our first four meetings, we had no "burdensharing" options. *Without any prompting, either through the materials presented to them, or* through any of our opening remarks, fully seventy-one percent (71%) of the groups in those first four exercises asked for "burdensharing" savings estimates; indeed many insisted on including such savings in their packages, whether or not we had the numbers; so we included those options for our meetings later in the year.

Most groups chose some burdensharing option(s), with the largest share of the savings resulting from assumptions about reduced U.S. troop strength abroad.

Social Security, Medicare and Progressivity

Almost all groups were concerned about "progressivity", as they considered options to restrain the rates of growth in social security and medicare. They looked for options which would bear more heavily on middle and upper income Americans and less heavily on the poor.

They would tax OASDI in much the same way as we tax other contributory pension benefits, increase SMI premiums and impose a fee schedule for physicians in Medicare.

Most groups also would restrain COLA's in some fashion -- if only to achieve additional short-term savings -- though our participants would have liked an option to exempt poor beneficiaries from COLA reductions.

Even when the Senior Citizen Interns did the exercise, an overwhelming majority of groups voted to restrain the rates of growth in social security and medicare; and the Interns' concern for protecting the poor elderly was especially evident as they approached that task.

Farm Price Supports

Most groups were willing to consider almost any option to save money in this area. The general feeling seemed to be: these programs cost too much, and they don't work.

Even in farm states, there is general dissatisfaction, and as noted above, participants in farm states seemed to feel duty bound to include cuts in agricultural price supports in their packages.

Revenues

There was less concern with progressivity in tax policy than in spending programs directed to the needs of the elderly population. There were a number of comments to the effect that nothing could be more regressive than the recent increases in social security taxes.

The groups that completed this exercise would raise revenues chiefly through higher excise and energy taxes, with a few "base-broadeners" included for good measure.

The only income tax option a majority of groups would support is a 33% bracket for individuals. Though the exercise did not offer them the option to do so, many groups commented that they would couple the higher individual rate with a capital gains differential.

The Social Security Trust Fund Issue

Late last summer, and early in the fall, we detected a growing concern over the social security trust fund issue. Today, we believe it would be hard to overstate the strength of public opinion -- even anger -- on this issue.

> More and more, people are beginning to understand that the social security trust fund reserve reduces the reported budget deficit; that the reserves are being used to pay for other government programs.
>
> More and more, people are saying: "The trust fund surplus is an illusion. There won't be any money there to pay for my benefits when I retire. This is not what I was promised when 'they' raised my social security taxes."
>
> You may ask, how could it be otherwise? Social security trust funds are, by law, invested in government securities.
>
> That is true, but if the non-social security trust fund budget were in balance, if we were buying down the national debt with the social security trust fund reserve, we would be reducing our debt service burden (and increasing net savings in the country). A smaller debt burden and higher savings rate (which should reduce the cost of capital, stimulate investment, and lead to higher productivity) should make it easier to meet our social security (and other) obligations in the future Besides, this shift toward paying for government with social security taxes just isn't fair. FICA is the most regressive tax the federal government ever has enacted.

We do not mean to suggest that average Americans have thought through and understand all the economics and government finance issues outlined above. We include this brief digression only to summarize for you the dialogue which took place in more and more groups as the year progressed.

The strength of feeling on this issue best is illustrated by the trend in deficit reduction packages among the groups which completed the exercise later in the year. These groups tended to be more concerned about the use of social security trust reserves to "mask" the deficit.

By the end of the year, most groups voted to move the budget into surplus by fiscal year 1993. Many produced quite substantial surpluses.

This compares to results earlier in the year, which tended to follow a classic bell-shaped curve: about 80% of the groups met the G-R-H targets; about 10% fell short; and about 10% produced surpluses by fiscal year 1993.

People seemed determined to end this "budgetary chicanery" as soon as possible, even if it meant supporting deeper spending cuts and larger revenue increases than otherwise would have been necessary.

You may ask, "If people are aware of the social security trust fund surplus, why would they vote to restrain the rate of growth in social security to balance the budget?"

Pepole want to spread the burden of deficit reduction as broadly as possible; and

> People are aware of the rapid increase in FICA taxes. Many groups expressed an interest in options to restrain the rate of growth simultaneously in both social security benefits and FICA.

(We did not include such an option in the exercise, so we cannot tell you how many groups would have supported it. We only can report that we got a lot of questions on that issue).

There also were discussions about cutting OASDI and using the increase in the trust fund surplus to offset all or part of the general fund subsidy in Part B Medicare. Several knowledgeable participants opined that this might be the only way to reduce the general fund subsidy to Part B of Medicare to the 50% contemplated when the program originally was enacted.

Finally, a majority of all groups seemed to feel we should tax social security as nearly as possible like we tax other contributory pension benefits. People seem to reach this conclusion on equity grounds, almost irrespective of the need to cut the deficit.

In short, the vast majority of groups which completed this exercise were convinced that every large area of the budget must contribute to deficit reduction, else they simply could not achieve the goals they set for themselves.

Conclusion

Mr. Chairman, Mr Archer, Members of the Committee, we have included copies of our printed report on this project with our testimony for each of you (and for the media).

This project proved, to our satisfaction, that the polling data on the budget deficit issue is not only confusing -- it is misleading.

People will accept the hard choices necessary to put our fiscal house in order -- but only inside the right package. Public opinion polls don't ask people about packages, thus the distortion and confusion.

Of course, if you ask people: do you want us to cut defense, or social security, or medicare, or transportation spending, or almost anything else in the budget? - almost everyone will answer with a resounding, "NO!"; if you ask, do you want us to raise your taxes? - almost everyone will answer, "are you crazy?".

In this project, however, group after group and city after city voted to do "all of the above".

The sample may be small, but the results are so surprisingly uniform that we believe they would not vary much -- no matter how often we did the exercise or where. (We may have an opportunity to test this thesis. Many of your colleagues have asked us to conduct the exercise in their home Districts this year).

We hope your Committee will find these results as interesting and illuminating as do we. Most of all, however, we hope you will find this useful in the task which lies ahead of you.

EXERCISE

IN HARD CHOICES

"On the Road"

November, 1988

John J. Rhodes

Robert N. Giaimo

The Committee for a Responsible Federal Budget is a bipartisan nonprofit organization formed to educate the public on the federal budget and on the federal budget process.

The Committee is Co-chaired by Robert N. Giaimo and John J. Rhodes.

Our thanks to the House and Senate Budget Committees and the Congressional Budget Office. Their staffs made a major contribution to the success of this project.

On The Deficit, The Public Opinion Polls Are Confusing and Misleading

Opinion Polls Report:

1. The American people want a balanced budget; and
2. The American people oppose any changes in laws and policies that would balance the budget.

The Exercise in Hard Choices "On the Road" project is an attempt to reconcile those two mutually exclusive conclusions.

What Did We Find?

(See centerfold for compilation of results.)

- People do want a balanced budget;
- Americans will support the hard choices necessary to balance the budget; but
- They will support those hard choices only as part of a package which is generally perceived to be fair.
- "Fair" packages spread the burden of deficit reduction broadly across interest groups and regions.
- If there are two "sacred cows" in the federal budget this year, they are education and environmental programs; they are not defense, social security, medicare, or revenues.

We conducted twelve Exercises this year involving approximately eleven hundred people. Seven were co-sponsored by Members of the House or Senate, in their home districts and states. Oklahoma Governor Henry Bellmon was our co-host for one meeting. Two of these sessions were university projects. The Congressional Senior Citizens' Intern program and the Aspen Institute Associates also completed the Exercise. Our Congressional co-hosts were four Democrats and three Republicans; Governor Bellmon is a Republican.

The Districts and States in which we conducted the Exercises were rural and urban, and included the west, southwest, midwest and east.

The eleven hundred people who completed the exercise may not constitute a statistically accurate cross-section of America; but the outcome of these Exercises was so consistent across the country that we believe almost any number of audiences, almost anywhere in the country, would produce similar outcomes.

The one issue on which we could identify a significant regional deviation from the norm is broad based consumption taxes.

In the midwest there was virtually no support for a VAT or a national sales tax. Throughout the rest of the country, there appears to be significant and growing support for some form of broad based consumption tax.

This "midwest deviation from the norm" puzzles legislators from the region, and it puzzles us. It may be the result of a different attitude toward Washington or big government; or the fact that our VAT/sales tax option raised a lot of money; but that is just speculation on our part.

On average groups cut expenditures and raised revenues sufficiently to produce modest surpluses on a unified budget basis by fiscal 1993. (See box below)

AVERAGE OUTCOMES

	FY90	FY93
Final Deficit (in billions)	87	23*
Expenditure Reduction	30%	51%
Revenues	70%	49%

* Surplus

(Continued)

As the year wore on, more and more participants became aware of the extent to which we are using the social security trust fund surplus to pay for non-social security functions of government.

- Almost all participants who realized that social security trust fund reserves reduce the reported deficit disapprove vehemently of that "ploy."
- Audiences that were more preoccupied with the social security trust fund issue tended to reduce the deficit faster than the Gramm-Rudman-Hollings law requires—indeed, they tended to produce substantial surpluses by fiscal year 1993.

Thus, the averages contained in the table on the preceding page are a little misleading.

- Early in the year results tended to fall into a classic bell-shaped curve: about 80% of our groups balanced the budget by 1993; about 10% fell short; about 10% achieved surpluses.
- By the end of the year most groups voted for surpluses by fiscal 1993.

The Exercise in Hard Choices is similar to a Budget Committee mark-up. It is conducted as follows:

- Participants are assigned to groups of eight or ten.
- In making assignments we attempt to ensure maximum diversity in each group, i.e., ideally, a group will include representatives of business, labor, education, retirees, farmers, etc., representing a cross-section of interests.
- Each group acts as a "Budget Committee." It selects a Chairman and a recorder, and it completes the Exercise collectively. Groups are not permitted to report multiple or minority results. As a consequence a small percentage (fewer than 10%) fail to complete the Exercise.
- At the beginning of each meeting participants are given an overview of the budget and the deficit. They are given directions to help them complete the Exercise.
- During the Exercise, Members of Congress and staff circulate among the groups, listen, answer questions, and join in the debate.
- At the end of each meeting groups report their results to the entire audience. There is an opportunity for discussion, questions and answers.

Perhaps the most surprising and heartening conclusion we reached as a result of this project is this: People go out of their way to find options which will affect them and/or their areas of the country.

- Groups across the country seem to understand that they cannot shift the burden of deficit reduction onto someone else's shoulders.
- In Sacramento, most groups voted to raise excise taxes on wine.
- In Arizona, cotton farmers were willing to raise prices for reclamation water.
- In the midwest, almost all groups voted to cut agricultural subsidies.

There were other equally clear indications that people are willing to assume their "fair share" of the burden. At table after table in city after city we heard the same refrain:

- Defense proponent asks table: What are you willing to do on social security and medicare?
- Retiree responds: What are you willing to do on defense and taxes?
- Some third party says: Why don't we try to do a little of everything?

Almost always that is what they do.

Our Budget Committees

Sacramento Decides
The Federal Budget

J. James Exon

"The Exercise in Hard Choices is a realistic and serious look at the tough budget decisions which face the Congress and the President. The seminar at Omaha's Creighton University challenged the participants to find solutions to our nation's fiscal problems, and to also find a consensus for those solutions. Not only did the participants learn a great deal about the federal budget; as host, I also learned from the recommendations of the participants. The Committee for a Responsible Federal Budget is to be commended for this excellent program."

Charles E. Grassley

"The title of this conference is very appropriate. The Exercise in Hard Choices. If *you* can make the hard choices, then *Congress* can too! The leaders at the federal level need to get the message. The American people want this problem taken care of. No ifs, ands or buts. Just do it! This exercise was part of that message. Your participation will play a positive role in solving our deficit problem. You have made a difference."

Jim Slattery

"When presented with the facts, the participants soon realized that there are no easy answers when looking for ways to cut federal spending. In turn, I gained a better understanding of which federal program cuts they were willing to support."

Amo Houghton

"It is terrific that so many busy people will take so much time in an effort to help our government come to grips with and solve this very serious problem; and it is clear that the participants in this meeting agree the problem is very serious indeed. I only hope the people in Washington will pay attention to the message we are sending them."

Martin Frost

"Those who participated in the budget options exercise discovered that reducing the deficit and achieving a balanced budget will require some tough decisions. However, after watching the Dallas participants work through the Exercise I am convinced that the American people will accept the difficult choices as long as any deficit reduction package is fair and balanced."

Henry Bellmon

"Those who attended the "Hard Choices" seminar here in Oklahoma were strongly in favor of both tax increases and spending restraints to get the federal budget back in order. This confirms the belief that citizens of Oklahoma and the rest of the nation are more than ready for the next President to lead the nation out of the federal budget morass."

Vic Fazio

"I had completed the Exercise several times before, but going through it with my own constituents in Sacramento was a very special opportunity for all of us. It is clear from the results of this meeting that the American people will accept the hard choices needed to balance the budget—even hard choices which affect them directly. I only wish all of my colleagues could go through this with their own constituents."

John J. Rhodes, III

"Our constituents may be ahead of their political leaders. One thing is clear, however, people want a balanced budget, and they are willing to accept the hard choices necessary to achieve that goal."

Hard Choices—

Defense Baseline	85% continue pattern of last three years (1.5% negative real growth).
Defense "Burdensharing"	Based on popular demand in first four sessions, we included burdensharing options in the Exercises completed later in the year. Nearly all groups chose some burdensharing option(s), producing savings on average of $4.7 billion in 1990, and $6.2 billion in 1993. The largest share of burdensharing savings resulted from assumptions about reducing U.S. troop strength abroad.
Medicare	More than 85% of all groups would support slowing the growth in Medicare. The majority would shift to prospective reimbursement for capital costs, impose a fee schedule for physicians and increase SMI premiums.
Social Security	Over 90% of all groups voted for some COLA change. The majority would either freeze COLAs for one year or change to 2/3 CPI for five years. 85% voted either to eliminate thresholds for taxation of social security benefits and/or to include 85% of benefits in adjusted gross income.
Veterans	Support for ending cash compensation for veterans with low-rated disabilities varied from 60% in early Exercises to zero in Iowa. On average, opinion on this option was equally divided.
Agriculture	Almost all groups would cut agricultural supports. Overall, about 75% would lower target prices, about 85% would restrict program eligibility, and about half the groups would change management policies at FmHA.
Student Loans	About 55% of the groups would reduce lenders' subsidies. About 35% would charge interest while students are in school.
Energy and Natural Resources	Large majorities of all groups would raise prices for commercial and recreational uses of federal lands and reduce federal power subsidies.
Transportation	87% of all groups would raise charges to cover transportation safety programs. About half would cut federal highway and mass transit spending.

What We Chose

Other Discretionary

82% of all groups would terminate EDA and UDAG, and about 68% would restrict eligibility and reduce funding for CDBG.

53% would raise interest rates for the rural housing loan program.

Fewer than 25% of all groups would eliminate grants for wastewater treatment plant construction.

A majority would discontinue postal subsidies for not-for-profit organizations, terminate ExIm Bank Direct Loan Programs, and eliminate cargo preference and related subsidies to U.S. Flag Vessels.

About 40% of all groups would cut funds for Health Professions Training and funding for the Arts and Humanities.

67% would close down inefficient or underused units in VA hospitals.

61% would trim the size of the civilian work force.

83% of all groups would modify Davis-Bacon.

Revenues

84% of all groups voted for a 33% bracket for individual income taxes.

No other income tax option—individual or corporate—received majority support.

About 30% of all groups supported a VAT or a National Sales tax. The percentage would have been above 40%, except that there was virtually no support in the Midwest.

88% of all groups voted to raise excise taxes on cigarettes, on beer and wine.

76% of all groups voted to raise energy taxes. A majority of all groups would increase motor fuels taxes. A bare majority would impose a fee on imported oil—or on both domestic and imported oil—or would impose a broad-based tax on all energy consumption.

71% would limit deductions for business meals and entertainment to 50%.

83% would phase out the child and dependent care credit between $50,000 and $70,000 AGI.

70% would extend HI coverage to state and local employees.

74% would impose pollution charges.

No other revenue option received even 40% support.

Exercise In Hard Choices

Budget-Trimming Exercise Teaches Acceptance

Seminar Participants Willing to Make Hard Choices, Raise Taxes to Reduce Deficit

By Tom Kenworthy
Washington Post Staff Writer

Sharon Barbosa of Irving, Tex., has a message for policy-makers in Washington: She's willing to pay the price for eliminating the huge federal budget deficit.

"We're all going to have to absorb some of the hard times," concluded Barbosa, the owner of a research and writing service, as she and several dozen other Dallas-area residents completed a three-hour budget-writing exercise last week sponsored by the Committee for a Responsible Federal Budget.

Along with similar groups in Oklahoma City and Sacramento, participants in the Dallas seminar learned some fundamental truths about just how much pain is involved in erasing the $170 billion in red ink that is projected to greet the next president: It would take wrenching spending cuts in long-cherished federal programs and probably the largest tax increase in U.S. history.

That hardly qualifies as news for most lawmakers and other federal officials in Washington, who know that last year's budget summit between Congress and the White House did little more than postpone the day of fiscal reckoning beyond the next election. But it might come as a surprise that voters—once they understand the depth of the problem and the options for coping with it—say they are ready to bite the bullet, as long as everyone else has to sink their teeth into it at the same time.

Conveying this message to the politicians is one of the primary purposes of the budget exercises that the nonpartisan, nonprofit committee will be sponsoring in other regions of the country this year.

As Oklahoma Gov. Henry Bellmon, the former ranking Republican on the Senate Budget Committee, said as he convened the Oklahoma City session: "Let them know what you think, and hopefully it may help strengthen their backbones."

How much spine-stiffening can be accomplished in the face of public opinion polls that show the American electorate strongly opposed to tax increases and tough spending cuts is a difficult question.

Few of those who participated in last week's budget sessions failed to grasp the political perils of their recommendations. "I'm glad people aren't voting for us based on what we said today," observed Ed Crone, an employee of the Eastern Oklahoma Development District.

In addition, the people who took part in last week's budget exercises were what politicians like to call opinion leaders: business people, local officials, civic leaders and elderly activists. The kind of voters who cannot take off three hours at midday to role-play a budget committee markup—blue-collar workers, for example—were in short supply.

Nonetheless, many of those who did attend came with the preconceived and common view that a $1.1 trillion federal budget must be marbled through with enough fat that truly unpleasant choices such as trimming Social Security or raising tens of billions of dollars in new taxes would be avoidable.

Pat McElroy, Jr., an executive vice president of a Duncanville, Tex., bank, for example, approached the task of cutting federal spending with gusto. He announced to his table in advance that cutting $70 billion from the fiscal 1990 budget to meet the Gramm-Rudman-Hollings budget law's goal of a $100 billion deficit that year should be done predominantly through spending reductions rather than raising taxes.

And when told that a $10 billion cut in the defense budget would probably translate into 65,000 lay-offs of uniformed and civilian employees in the Defense Department, McElroy was undaunted. "I've always wanted to lay off 65,000 people," he said. "Let's go for it."

Yet by the time McElroy's group had completed its exercise, it had voted to raise

(Continued)

taxes by $51 billion in fiscal 1990 while cutting spending by $33 billion.

Working from a set of policy choices prepared by the Congressional Budget Office, other groups in the three cities came to similar conclusions. Achieving the $70 billion in deficit reduction that will be required next year under the Gramm-Rudman-Hollings law, most participants discovered, necessitates going to big-ticket items: the $300 billion defense budget, the costly entitlement programs such as Social Security, Medicare and agricultural subsidies, and higher taxes.

Among the conclusions, which will be presented to Congress and the National Economic Commission formed early this year to advise the next president on how to eliminate the deficit, was one predicted by Carol Cox, president of the committee. "Contrary to conventional political wisdom, there are no sacred cows," she said.

Many of the groups, for example, found consumption taxes far more attractive than individual and corporate income taxes, and not just the obvious ones such as gasoline and tobacco taxes. In addition, there was widespread support for a value added tax, a form of national sales levy that many policymakers view as regressive.

The main virtue of a national sales tax, many participants found, is that it raises big money, $44 billion the first year if set at 5 percent, and would penalize consumption rather than wage-earning.

"Why are we taxing people when they work, but not when they spend?" asked Bruce Thevenot, executive director of the Oklahoma Nursing Home Association.

Another conclusion that cuts across the grain of political wisdom in Washington is that voters, even elderly ones, will accept some cuts in Social Security and means testing of Medicare as long as they do not feel they are being unfairly singled out.

"If a remote (military) base in Texas is sacrosanct, don't come to me talking about Social Security," warned 75-year-old Everett Anschutz in Dallas as he pushed for a fairly steep cut in defense spending. Shortly thereafter he joined a majority of his group in voting to forgo one year's cost-of-living adjustment (COLA) for Social Security recipients—a savings of $8.8 billion. "If I have to pass up a COLA, so be it," he said.

For members of Congress such as Sacramento's Rep. Vic Fazio (D-Calif.), this offers some hope that voters who are asked to sacrifice will not punish them at the polls as long as the pain is equitably distributed.

"If you can come to a district as diverse as this one and talk equity, they'll buy it," Fazio said.

Washington Post, April 10, 1988

Exercise In Hard Choices

Get Ready, Set, Calculate!

'Congressmen-For-A-Day'

By Chuck Massaro
Times Hearld Staff Writer

About 75 Southern Tier residents spent four hours with nine calculators and . . . (poof) . . . no federal deficit.

Some of the region's best minds were called upon by Congressman Amory Houghton (R-Corning) and the Committee for a Responsible Budget to see what they would do if they were federal lawmakers facing the mammoth task of reducing a $136 billion federal deficit.

None of the groups of the temporary congressmen, armed with the budget ax and the power of taxation, knew their mock budgets would be used by Mr. Houghton as unofficial guidelines of how his constituency would like him to act during the next budget period.

Results of the mock budget session will be incorporated into a report to the National Economic Commission which was set up soon after last year's stock market crash. Results will also be delivered to the Congressional Budget Committee.

The Exercise was designed to provide the input to goverment, but also to show community leaders how a federal lawmaker must agonize over the budget each year. The participants each received a booklet, or menu, listing various federal programs and the costs of each.

For example, if the group decided it would like to weaken the United States military's Pacific force by 10,000 men and women, it could subtract $200 million from the deficit.

Or, increase your health insurance deductible from $75 to $200 annually, and the group would be able to shave off another $1.1 billion.

Those assembled in Olean's Old Library restaurant Tuesday took the excercise seriously, said Robert C. Watkins, a retired Corning Glass development gauge builder and chairman of "table no. 12" during the exercise.

Participants represented business, industry, agriculture, education, retirees and many other parts of society.

"Some topics drew considerable conversation. Everybody wanted to express their views and lend their expertise," said Mr. Watkins.

Before each group made its final report, Carol Cox, president of the Washington-based Committee for a Responsible Federal Budget, said they would tax more than they expected to. She was correct. Her prediction was based on about one dozen such exercises she has conducted throughout the nation. She also made the prediction that the Olean groups would leave education untouched in the budget. She was right again.

Each of the nine groups was successful in eliminating the deficit and even projecting surpluses, by Gramm-Rudman's target date of 1993. To get there, each group used the power of taxation more than it did the budget ax.

"We doubt if we'd get re-elected," kidded Dennis Wolberti of Elmira's Facet Enterprises Motor Components Division after he announced his group would raise gasoline taxes 50 cents per gallon in order to generate a quick $45.3 billion in revenue to apply toward the existing $136 billion deficit.

Most, if not all, of the other groups would also have raised gasoline taxes 50 cents per gallon.

If the 75 congressmen-for-a-day had their way, taxes on cigarettes, beer and wine would rise. They mentioned assessing a 5 percent surtax on individuals and suspending indexing of standard income tax deductions and personal exemptions for a year.

Some were in favor of applying a national sales tax and raising income taxes on married couples with two children who earn taxable incomes of more than $200,000.

As for spending, national defense fared well, farm subsidies virtually disappeared, and actions on medical and social security benefits were mixed.

"Until this exercise," explained Rep. Houghton midway through the day, "these people were watching from the sidelines. Now they have been thrown into the pond and they will each have to emerge and tell what was at every level.

"They will have to set priorities, realize they can't have everything, and make cuts, all the time remembering they promised to represent all the people of their district.

"They will have learned that when it comes down to it, there are no easy choices—you can't stall economic growth, but you can't have the institution bankrupt either.

"They may find, like some in Congress do, that it's difficult to make budget cuts—the tough decisions—and easier to throw up their arms and raise taxes," continued Mr. Houghton.

"Such congressmen point to the White House and say 'it's your fault.' They then hide in the numbers, saying they are only one of 535."

Olean Times Herald, Olean, N.Y., Nov. 2, 1988

Exercise In Hard Choices

Nebraskans Wrestle With Federal Deficit

By John Taylor
World Hearld Staff Writer

Some of Nebraska's community leaders and ordinary citizens gave Congress a demonstration Tuesday of how to draft a federal budget.

About 100 people participated in a seminar in which they were asked to prepare a federal budget for fiscal years 1990 and 1993.

The seminar, at Creighton University's Student Center in Omaha, was sponsored by the Committee for a Responsible Federal Budget and by Sen. J. J. Exon, D-Neb.

It was one of several such meetings called "The Exercise in Hard-Choices," the committee is holding nationwide. When the sessions are completed, the committee, a non-profit organization, will compile the results and distribute them to the presidential campaigns, to budget decision-makers and to the newly created National Economic Commission.

Exon, addressing the group, said that the next president "will inherit a fiscal headache."

Annual budget deficits, he said, will hover between $170 billion and $200 billion. In fiscal 1987, the budget deficit was $150.2 billion.

Participants at the Creighton exercise were divided into groups of seven to 10 people.

Each group came up with various ways to reduce the federal deficit, through spending cuts and increased taxes, to levels within the guidelines established by the Gramm-Rudman-Hollings anti-deficit law.

Here's how one group of seven people handled the federal budget:

- The group reduced the Defense Department's budget-by $7.6 billion in fiscal 1990 and by $10.2 billion in fiscal 1993.
- Entitlement programs—Social Security and farm subsidies—were reduced by more than $12 billion in 1990 and by $28 billion in 1993.
- Federal revenues were increased $48.3 billion for 1990 and $65.3 billion in 1993. The group—six men and a woman—favored imposing a 5 percent surtax for individuals, instituting a 33 percent tax bracket and assessing a 12.5-cent-per-gallon gasoline tax increase.

If the group's suggestions were adopted, the federal deficit would be $85.8 billion in 1990.

By 1993, the budget would show a $17 billion surplus.

World Herald, Omaha, Neb., June 1, 1988

Exercises In Hard Choices

CITY	DATE	CO-HOST
Dallas	April 5	Representative Martin Frost
Oklahoma City	April 6	Governor Henry Bellmon
Sacramento	April 7	Representative Vic Fazio
Phoenix	April 8	Representative Jay Rhodes
Omaha	May 31	Senator James Exon
Des Moines	June 1	Senator Charles Grassley
Topeka	June 24	Representative Jim Slattery
Olean	November 1	Representative Amo Houghton
Washington, D.C.	April 27, 1988	Colgate University
Washington, D.C.	May 24, 1988	Congressional Senior Citizens Intern Program
Aspen, Colorado	August 8, 1988	Aspen Institute Associates Program
Syracuse, New York	October 31, 1988	Syracuse University

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Robert D. Kilpatrick
Arthur Levitt, Jr.
Leland S. Prussia
Alice M. Rivlin
Elmer Staats
Paul A. Volcker

STATEMENT OF HON. RICHARD BOLLING, MEMBER OF THE BOARD, COMMITTEE FOR A RESPONSIBLE FEDERAL BUDGET (FORMER CHAIRMAN, HOUSE RULES COMMITTEE)

Mr. BOLLING. Thank you, John, and Mr. Chairman, thank you very much for your courtesy and kindness. I have very little to say except that we are actually a bipartisan group, and the opinions expressed by John are the opinions of the whole group.

We feel very strongly that at least a very large number of the informed people in the United States do take the budget deficit seriously, and I think both John and I would agree, that since you are on the firing line, and you know the current situation and the current maneuvering, that only you are the ones that can put together the packages.

But I think it is important that the packages be put together. I think it is of the same importance as some of the packages that I would compliment you for putting together in the last couple of years.

I think it is extremely important that we get this thing behind us because I do not find, in any history, any place where a country that was in serious deficit in the world turned out to be a very good leader for very long.

And I think the stakes that we play for when we deal with deficits, and continuing imbalances, and the amount of money that we owe to other countries are very high, and I know you feel just as seriously as I do about it, and that you will do your best to meet that problem as quickly as you can, and all I can add is that I wish you the very best of luck.

And I feel comfortable, when I look around, not only at the people that are here, but I look at the ones that are not, in terms of the quality of this committee.

This is a first-rate committee with first-rate people on it, and I know that it will do its best to deal with the problems that you face.

Chairman ROSTENKOWSKI. Well, Mr. Bolling and Mr. Rhodes, thank you very much for your confidence. I hasten to add that we here on this committee have had some very difficult tasks to perform, and because of the cooperation on a truly bipartisan basis, we were able to influence, on the Floor of the House of Representatives, support enough, so that we could pass some programs.

I think that in great measure, without a bipartisan effort, and the support of both Democrats and Republicans, we could not have accomplished a welfare reform bill, a catastrophic health bill, the trade bill, the Canada-United States Free Trade Agreement, the Tax Reform Act of 1986. Those are things that surfaced out of the Committee on Ways and Means, and I think are truly legislative giants in the galaxy of legislation.

And so I am truly proud to be chairman of this committee, and I am proud of the fact that in most instances, if not all, the Ways and Means Committee has accepted its responsibility and followed through, sometimes painfully, but at least having the confidence of the membership and the American people, to have followed through with legislation that sets out, I hope, good policy. Mr. Pickle.

Mr. PICKLE. Well, Mr. Chairman, these two gentlemen and the committee they have been representing bring us very important information. It is real world information, and I think the conferences I have held in my district reflect pretty much what the meetings you have held across the country reflect.

People are concerned about the deficit, and they are willing to sacrifice to do something about it. And I think you would find a majority of people feel that way, and they are waiting, I think, for the Congress to give them something they can buy.

Now whether we can put together a package like that remains to be seen. I am hoping that we can because we simply must do something about reducing the deficit.

Now let me just ask you for my own information, with respect to your meeting, how did you get the group together? Did Governor Bellmon just invite the public to come in, or did he pick them out by groups?

In other words, who are the people who met? Can you identify them enough to tell the Congress, the composition of these groups?

Mrs. COX. Mr. Pickle, I expect you have in your office, back in your district, a list of businessmen, of people affiliated with the education community, people affiliated with the transportation community, people affiliated with organized labor, people affiliated with retired organizations—all the various people that you talk to and see, and mail things to throughout the year.

Both your colleagues and Governor Bellmon, compiled all those lists together in one list, and typically, we would send out invitations to about 1,000 people, and get between 100 and 200 respondents who would come to the meeting.

We would take those people and very deliberately, when we divided them up into groups, make sure you had a business person, and you had an educator, and you had somebody from the retirement community, and you had a student, a farmer, et cetera, so you had a cross-section of people at each of the tables. So it more or less reflected the kind of push and pull you have here.

If I may, I will tell you just one little story because I told it in public yesterday and Jim Exon did not seem to mind it.

In Omaha, Nebraska, we had one table that was chaired by the fellow who heads the State taxpayers association, and another table that was chaired by a fellow who heads the union lobbying effort in that State. You would think those two tables would produce very different results.

But, you know, they chuckled, and so did we when it was all over. Their packages were so close they could have swapped. They were absolutely surprised, their groups were all diverse, and yet they came up with very similar deficit reduction packages.

Mr. PICKLE. Well, we might have the same kind of cooperation if my friends on the other side of the aisle would just listen to our proposals, and I am sure that they will.

Tell me about Social Security. You would take it off the budget, but you said in spite of the fact that you are making a recommendation to restrain the growth.

How would they restrain the growth of Social Security?

Mrs. COX. In two ways, sir. In the short-term, most groups seem willing to accept some kind of COLA freeze. For the longer term, they seem to prefer changing the tax treatment of Social Security so that you tax it more like you do private contributory pension benefits.

But it was a combination of the two, and one of the surprising things was that even the senior citizens interns group, here, in Washington with which we have done this exercise for 4 years in a row—in even that group a substantial majority of the tables voted to restrain the rate of growth in Social Security.

Mr. PICKLE. Well, do you have for this committee some documentation of their recommendations on how they will would restrain it?

Mrs. COX. Absolutely.

Mr. PICKLE. Well, I would like to have that.

[The information was supplied directly to Representative Pickle.]

Mr. PICKLE. In your meetings, did you talk at all about the other expenditures that have been suggested to us? We are trying to balance the budget, and yet we have had the recommendations of expenditures of $20 to $30 billion for long-term health care, home care, and child care, among others. Did any of that come into the discussion?

Mrs. COX. In that respect I confess to you that this exercise was not like the budgets you do in Congress. This was a deficit reduction exercise, and while the groups talked about other new priorities, and they recognized that the numbers that they were looking at did not have any of those in them, it took the groups fully 3.5 or 4 hours to go through just the deficit-reduction exercise without going through the full-blown budget exercise you go through.

Mr. RHODES. I think it is fair to say, also, Mr. Pickle, that the elements which you mentioned, the S&L situation and all, have made this pretty much a brand-new ball game in many ways, as far as a balance is concerned, and a lot of what happens to the idea of a balance depends on how the Congress and the President solve this issue, which has certainly been in the wings for a long time, but has only recently come into being with the full dimensions apparent to all of us.

Mr. PICKLE. It would seem to me that we might get bogged down—you or us—in trying to figure out the details of how we put a package together.

I can understand their fear that Social Security funds would be improperly used. There is a budgetary imbalance in effect for the administration, and that we ought not use the funds to hide it. I guess you could argue just as well that, to the extent it may not reduce the deficit but keeps us in a little more sound economy, it is worthwhile.

We get divided on those things, but overall, you are saying that the people, the cross section, want us to do something about the deficit and they are willing to sacrifice to see that it is done, if we can do it together as a package?

Mr. RHODES. That is the bottom line, Mr. Pickle.

Mr. PICKLE. Thank you.

Chairman ROSTENKOWSKI. Mr. Rangel will inquire.

Mr. RANGEL. Thank you, Mr. Chairman.

Both of my colleagues know that the greatest thing about the Congress is how we all can send out questionnaires, and then you start reading the results and you wonder whether we are in the same country.

But still, I look at the questionnaires as they come out of the printers, and it is very interesting because this group that you interviewed, if I understand it correctly, they only had two sacred cows, and narcotics and housing was certainly not included as one of those cows.

That they were really opposed to any increase in income taxes. I mean, even if we were talking about higher income-tax brackets, that they really were willing to accept a consumption tax right across the board, where everybody, regardless of income, would pay it.

That is broad-based consumption tax. And when they got to Social Security, why, this great group of Americans were even prepared to have their COLA's frozen, as we protected the environment for them.

So, I know that I will include this among the many questionnaires that the other members have sent out, and I think that is what makes this a great country, because my questionnaires do not really come in anywhere near like this, and I just wondered how you have managed to get this group to be concerned about progressivity as it related to the restraints of the growth in Social Security and yet they were not concerned about it at all as related to the excise taxes.

Mr. RHODES. Well, Mr. Rangel, may I reply to that?

Mr. RANGEL. Sure.

Mr. RHODES. Actually, you just made a very important point. I agree with you, that if you take these items which we presented to these people, one at a time, you will get the results that you just mentioned.

But the point that we are trying to make is that if you present it as a package which seems to be fair to everybody, and everybody has to sacrifice a little bit, but he does it because everybody else is, too, you get an amazing consensus because people really do want to do something about the deficit.

Mr. RANGEL. This tax package, Mr. Rhodes, taxes everyone across the board regardless of their ability to pay, and excludes even the consideration of changing the rates.

Well, when you say a broad-based consumption tax, isn't that across the board, Mr. Bolling? If you talk about gasoline tax, isn't that across the board?

And when you talk about not touching the rates of taxes—I mean, we were not talking about low income or moderate income, because I listen to the people who come here every day saying, for God's sake don't change those rates. You know. Let's get a broad-based consumption tax.

Well, I know they are looking at me when they say it, but it is all right because a lot of people believe, that if you are talking about paying the fair share, that those in the higher income-tax brackets, who in the last few years found that to fall from 70 percent to 28 percent, ought to be paying their fair share.

And to increase the cost of a loaf of bread and a quart of milk, whether you do it by increasing gasoline tax and passing it on to the consumer, it is unfair for a person to pay that increase when they have an income below the poverty line, as opposed to someone that is very wealthy where it really does not make any difference, what increases you have in excise taxes.

Mr. BOLLING. Mr. Rangel, in that particular field, the indication was that they were prepared, the people in these meetings were prepared to do something about the 33 percent rate.

That was the one thing that dealt with rates. The other points that you make are I think significant, because they indicate that the people that were interested in this kind of thing were not from the group that are the least successful without any regard to whether it is their fault or the accident of history.

The poor, I am sure, were not very well represented at these meetings, and they seldom are, and it is good that there are Members of Congress that do represent them.

But these groups were—I would think they might have been middle class and upper income. Inevitably, that is the nature.

Mr. RANGEL. I do not have any problem with that because they need representation, too. Let me ask my final question.

If you shift the Social Security trust fund out of the budget completely, it seems to me that from what staff has given me, that the Social Security fund reduces our deficit in 1990 by $68 billion, and in 1994 by $117 billion.

If you took that out, of course, then all of the projections we have had in budget reduction would just be out of the window, and it would mean that instead of a $100 billion deficit in 1990, we would have a $168 billion, and in 1994, instead of zero we would have inherited a $117 billion deficit.

This of course means that we borrow more money, and pay more interest, and I was wondering whether that was a consideration when you mentioned taking the trust fund out of the budget reduction, the deficit?

Mrs. COX. Mr. Rangel, I only can report to you the groups that were concerned with the way we are using the Social Security trust fund reserve today, were inclined to balance the budget sooner and produce larger surpluses by 1993.

They understood that you could not likely, in any circumstances, balance the budget without the Social Security trust fund reserve by 1993. No group managed to do that. But they seemed to feel that you need to reverse this trend, and either run quite substantial surpluses on a unified budget basis, sometime in the near- to medium-term future to reflect those Social Security trust fund reserves, or attempt to balance the budget some time in the near-term future without counting the Social Security trust fund surpluses.

They do not think that is why you raised their FICA taxes in 1983, and they really do not feel very comfortable with what we are doing today.

Mr. RHODES. And we might also say that the main thrust of the objection of the people was that the money was being used for non-Social Security purposes.

Most of them would say that if you would use part of the Social Security trust fund to reduce the subsidy on part B Medicare, or something like that, which is Social Security, that would be fine.

But I think the thing they object to is that it is not being used for that purpose. And also, I would remind the gentleman from New York, my good friend, that they did say—practically all of them—that they would support an increase in rates to 33 percent. Now that does not mean I would, or that everybody else would, but it does mean that the majority of the people that were on this did.

As far as a consumer tax is concerned, it was not favored in the Midwest. It was favored in certain other parts of the country. It is, as you know, a very controversial item.

Mr. RANGEL. That is why you and I agree, Mr. Rhodes.

Chairman ROSTENKOWSKI. Mr. Brown will inquire.

Mr. BROWN. Thank you, Mr. Chairman.

I might say, at the start, that I share our witnesses' confidence in the committee. In the brief time I have had on the committee they have taken on some pretty tough issues, and it seems to me worked out some reasonable compromises, and one can only lament that we do not handle the appropriation function as well as the revenue function.

I say that somewhat seriously, because I think what is important in the function these folks have performed, is that they did it with balance, I think sometimes our specialization in Congress slants our perspective.

The folks who have the pleasure of raising the taxes sometimes tend to be a little more careful with their spending. So I think the balancing act is an important one.

I want to congratulate all of you on a superb job that you have done, and what I think is an important contribution to perhaps the most important debate in this Nation.

You know, John, I have done this a little bit in my district over the years, not nearly as sophisticated as your group has, but I want to volunteer, and I hope that you or Dick, or both of you might come out to Colorado.

We have had many folks in Colorado volunteer to save some money on the Central Arizona project. I do not know about the Missouri projects. Seriously, however, we would very much like to be included in it and be active in it.

I might just add a note, if I could, to your observation about these compromises being worked out. We have maybe 20 to 40 town meetings a year in my district. We have probably an average of a 100 or so citizens attending.

I have never had a single person at any one of those town meetings, in 8 years, not willing to take a freeze in the portion of the budget that affects them.

That includes the elderly, the young, those on Social Security, or those on Medicare/Medicaid. But the one provision that they always insist on is that everybody else be in the same boat, be treated the same, and, I think if I were to identify a mistake this Congress has made in the last few years, it has been our unwillingness to be even-handed about the pleasure or pain.

I noticed in your information here, that the folks arrived at a recommendation that a portion of Social Security would be taxed, and I think it proposes taxing 85 percent of benefits.

Was there a reason, or a rationale for picking 85 percent?

Mrs. Cox. Yes, sir. Mr. Brown, there have been a number of studies in recent years trying to determine what portion of Social Security benefits you would tax, if you taxed the amounts that people get back, over and above the amount that they put into the system.

And for the average Social Security recipient, only 15 percent of the benefits that they get back represent their own contribution.

The balance of that, the 85 percent, on average, is the amount a person gets out of Social Security more than they contributed to it.

Mr. Rhodes. May I interrupt just a moment. The gentlemen leaving the room now are members of the Turkish parliament, who are here, in the United States, and they will be going from here to Phoenix, Arizona. Then they are going up to the Grand Canyon, and they will probably see the Central Arizona project, and I am just very pleased that they are in the room and have had a chance to see this great committee in action.

Mr. Rangel [presiding]. Well, if the gentleman would yield, on behalf of the chairman and the committee members, we welcome them to the committee, and to the Congress, and to the United States, and when you get to the Colorado, you are seeing the best that we have to offer.

I yield back.

Mr. Brown. Thank you, Mr. Chairman. I wonder, the 85 percent, is that adjusted for constant dollars, or is that a stated dollars analysis?

Mrs. Cox. It is adjusted in the sense that it imputes interest to the contribution you yourself would have made, sir.

Mr. Brown. I noticed in defense they came up with something that came close to a 1.5 percent negative real growth.

Did you get comments about our efforts to assist the Japanese and the Europeans? Were there recommendations in this area?

Mrs. Cox. Probably the most astounding thing that happened in this exercise, Mr. Brown, is in the first four exercises we did this year, we did not have any options for burden-sharing, the shifting of the burden of helping to defend the Far East and Europe, and fully 71 percent of the groups in those four exercises literally demanded to know how much money we could save in that respect.

And so, in the subsequent exercises we did this year, we did include some of those options. I must say to you that there was a strong sentiment that we could save some money there, and that people were willing to do it basically by reducing personnel expenditures.

Mr. Brown. Thank you, Mr. Chairman.

Mr. Rhodes. Thank you, Mr. Brown.

Mr. Rangel. Mr. Coyne.

Mr. Coyne. I have no questions.

Mr. Rangel. Mr. Chandler. Mr. Andrews.

Mr. Andrews. I am sorry that I did not hear your testimony. Let me just ask you a question, if you would expand just a little bit. If you had to make policy—and I know that is what you have tried to do for our committee—and could recap your suggestions, what would be, on the short-term, the most important things we could do as a committee?

If you had a wish list, and be specific please, what would you suggest our committee move forward on first.

Mr. **Rhodes.** I was afraid nobody was going to ask that question. I thank you for it, and, Mr. Chairman, I would like to insert in the record at this point a comparsion which has been completed by Mrs. Cox and the staff of the committee, and it has to do with the point that Mr. Andrews just made. This comparison makes clear the point that Congress has several times come close to a package—and each of those packages looked very like every other one.

[The information of Mr. Rhodes follows:]

"Attachment B"

"The Big Deal" That Almost Made It (several times)

Attached is a comparison of the "Domenici-Dole" package, the third Senate offer to the House in the Conference on the FY 86 Congressional Budget Resolution (August 1985), and the "2% Solution" from the budget summit (November 1987).

There have been other instances in which Congress and the White House -- and/or bipartisan groups in Congress -- got close to agreement on "The Big Deal".

- The "Gang of 17" (Spring 1982)
- The Senate Finance Committee (Fall of 1983)
- The Leath-Slattery-McKay amendment to the FY 86 Budget Resolution in the House Budget Committee and on the House Floor (Spring 1985)
- The "Penny-Tauke" group amendment to the FY 89 Budget Resolution in the House (Spring 1988)

On the spending side, all of those packages were very similar to the two examples we compare. The bigger the package, the larger was the revenue component (both in absolute dollars and as a percent of total deficit reduction). Very large packages tended to include significant energy tax increases. (In our Exercise in Hard Choices "On the Road" project, participating groups also tended to include substantial energy tax increases in packages to balance the budget or to produce budget surpluses by FY 1993.)

Alternative approaches to reducing the net cost of social security.

When the House Leadership was considering the Domenici-Dole proposal, then Speaker O'Neill said he would prefer to tax 85% of social security benefits, rather than to freeze COLAs. A number of groups outside government have endorsed changing the tax treatment of social security (taxing 85% of benefits and/or eliminating the thresholds). Under current law we tax 50% of benefits for individuals with incomes over $25,000 -- and for couples with incomes over $32,000. Eliminating the thresholds and taxing 85% of benefits would conform the tax treatment of social security as nearly as possible to the way we tax other contributory retirement benefits (and reduce the deficit nearly $20 billion in the third year after enactment).

Nonetheless, COLA freezes/modifications continue to pop up as part of large deficit reduction packages.

	Domenici-Dole
"Double up COLA"	For non-means tested programs, COLAs would be paid every other year in even numbered years (4.1 percent in January 1986, none in January 1987, 8.6 percent in January 1988). Savings FY 86 -88 $12 billion.
Domestic freezes, cuts	Would have terminated, cut or frozen a long list of domestic programs from general revenue sharing to transportation, to housing and veterans. Also included a number of asset sales and user fees, and reduced subsidies for a number of business-like activities of the government. Savings FY 86-88 $28 billion.
2% BA restraint domestic discretionary programs	Cap domestic discretionary appropriations at 2% nominal growth. Savings FY 86-88 $5 billion.
"Double up Indexing", taxes	Taxes would be indexed in CY 1986 as in current law, but thereafter would be indexed every other year in the even numbered years. Deficit reduction FY 86-88 $7 billion.
Expand HI/SS coverage	Require state and local governments and their employees to pay the medicare portion of social security taxes. Deficit reduction FY 86-88 $8 billion.
Oil Import Fee	Assumed a $5 per barrel on imported crude oil, and a commensurate fee on refined petroleum products, with 20 percent of the revenues to be used to provide relief to regions that are abnormally dependent on imported petroleum and petroleum products.

	2% Solution
COLAs	Limited to 2% per year for two years. Savings FY 88-89 $17.4 billion.
Other Entitlements	Mainly agriculture and health care (Medicare). Savings FY 88-89 $10.7 billion.
Modified Freeze	Limit growth in discretionary spending (defense and non-defense) to 2% nominal for two years. Savings FY 88-89 $16.3 billion
Revenues (2% cap on indexing)	Limit indexing in the tax code to 2% per year for two years. Deficit reduction FY 88-89 $4 billion. (Additional deficit reduction FY 90 $12 billion. Calendar Year/ Fiscal Year overlap causes the effects of this change to lag behind other provisions.)
Revenues (Other)	Essentially the package enacted as part of the budget summit agreement plus Extension of HI/SS coverage and/or higher excise taxes on beer and wine and cigarettes. Deficit reduction FY 88-89 $32.0 billion.

Similarities:

- Cola Changes for all non-means tested programs including social security.
- Modified freezes -- hold the growth of defense and/or non-defense discretionary spending to approximately one-half the projected rate of inflation.
- Modify/delay indexing on the revenue side of the budget.
- Other revenue increases (eg., Extend HI coverage), user fees and asset sales proposed by the Reagan administration; and/or some increase in excise taxes.

Differences

- Dole-Domenici, if enacted, would have balanced the budget by 1990; The 2% solution would have cut the deficit to below $100 billion.
- Dole-Domenici was a three year deal; the 2% solution was basically a two year deal.
- The biggest difference is that Dole-Domenici would have increased energy taxes quite substantially; and the 2% solution would not. That is the principal reason Dole-Domenici would have balanced the budget and the 2% solution would not.

Mr. RHODES. Actually, this is not how we would go about it, but this is a study based on the studies made by the Gang of Seventeen some years ago, by the summit of the Congress and the Reagan administration, and areas that they almost did—they were very close to agreeing on these, and finally did not do it.

And if they had gone ahead and agreed on them, you would have been able to balance the budget in 5 years.

And at the request of the board, Mrs. Cox did this study, and it will be available in the record, and if you would like to use it as a blueprint as to what—not us—but other people, who are probably as knowledgeable, or more knowledgeable than we, believe would have balanced the budget.

And we think that they still would, although as I mentioned, when I was in my colloquy with the gentleman from Texas, that the S&L situation probably gives us a brand-new dimension that we have not been able to measure yet. Nevertheless, the fact remains that these options are still valid and still would go a long way toward the goal which we all want.

Mr. ANDREWS. Well, let me ask about the revenue side. If we were to find ourselves in a position where we needed additional revenues, what would be your thoughts?

Mr. RHODES. I cannot speak for the committee because the board of directors of the committee has not addressed itself to any specific items. But from what we got from our study—and you were not here when we mentioned this, but you have got a copy of this—and you will notice in here, that the people who participated in this study—and there are over a 1,000 of them around the country—were ready to take a package which included an increase in rates up to 33 percent.

Now that does not mean that I would. That does not mean that the committee would. But it does mean that the people who did this study would.

And I do not know whether that would do the job, or not, but they also were not backing away from certain excise taxes. I guess they did not really have a set of priorities as to how they would prefer to enhance revenues, but there are areas in here which they did not back away from.

Mr. ANDREWS. Congressman Bolling, would you have a wish list if we had to go to some kind of revenue bill? After cuts in spending are made, if we still see the need to raise revenue, would the rates be your first priority?

Mr. BOLLING. Yes. The 33 percent would be a beginning effort. I am not sure what it ought to be. I would have to know what the current situation is and who would be affected, but I think that the rates came down too low to pay the price to get the other things done, and I think the other things that were done, with the elimination of a variety of shelters, was very worthwhile, and one of the reasons that I felt—even though I was not here—that the Tax Bill was worth supporting—at least in conversation outside—was that it would be very easy to change the rates if the political votes were there.

I think that obviously one of the problems that we face in this whole process is that a very substantial number of people, not just the people who are poor, but feel that we do not have a fair system at the moment, even though it is an improved system, because the people in the higher brackets, in the much higher brackets, just do not pay in a progressive way.

Mr. ANDREWS. Thank you very much for your testimony today.

Mr. RANGEL. Mrs. Johnson may inquire.

Mrs. JOHNSON. Thank you, and thank you very much for your presentation. I hope that in the next round you could see your way to including in your exercise some of the new issues that are facing the Congress, so that people would have a chance to not only say what they would cut, but to make it clear to us that they would be willing to forego new support for low-income families for day care, initiatives to deal with the lack of health insurance among the uninsured, or health coverage for the poor.

You know, some of those issues that the Congress is really struggling with at this time, and issues that we perceive as being issues, that must be addressed in spite of the deficit.

Have you considered this and have you piloted that?

Mrs. COX. We have considered it, Mrs. Johnson, and we are right now working to put together an updated exercise. We do update the exercise each year to take into account the real issues you and the President are considering.

There always is tension between what we would like to do and the time people will allocate to do it, but we do recognize that there are some new realities, and we will try to include a limited number of those in the updated exercise this year.

Mrs. JOHNSON. The other aspect of your exercise that interested me very greatly were those questions and those comments that came up from the work groups in regard to Social Security.

I think the fact that people realize that FICA taxes are very regressive and burdensome is important for us to remember here. Equally surprising in your testimony was the willingness of people to have Social Security benefits taxed as nearly as possible like contributory pension benefits.

If that is sustained by your other work shops it will be equally important.

Last, as a member of the subcommittee that is struggling with Medicare—and you know this committee has taken the bit and been responsible for the primary savings in the budget that Congress has adopted in the last few rounds, and is once again probably going to be faced with a need to reduce the rate of growth in Medicare—I was surprised at the willingness of your groups to cut Medicare benefits, and, particularly to cut the public subsidy that goes to Medicare recipients.

Could you enlarge a little bit on how Medicare and its costs played out, because just for the record, we are facing the reality that a $100 billion program is going to increase almost $50 billion in 4 years, and that will certainly reduce our ability to deal with the problems of poor children, as well as other interests in our society.

Mrs. COX. Mrs. Johnson, I can tell you, for one thing, that AARP was one of our cosponsors in this project, and as a consequence we had some of their members at each of the meetings we did around the country, and therefore, the benefit of some very knowledgeable people around these tables on the issues.

If you look at their Medicare savings recommendations or options, or selections, you find that there is a kind of balance within a balance in Medicare.

They took a little bit out of the hospitals in applying prospective reimbursement to the capital cost of hospitals. They took a little out of the hide of physicians by saying they would indeed adopt a fee schedule for reimbursement of physicians.

And then when they got to the beneficiary side, quite deliberately, almost all of the groups shied away from higher deductibles because they felt that fell only on people who were sick when they were sick, and chose instead to increase costs to the beneficiary of the SMI premium, to reduce the public subsidy to that.

Because at least it was spread over the entire beneficiary population and they thought that was fairer than to just have the people who were sick pay when they were sick.

Even the elderly folks in the audience seemed willing to say, look, we have got to restrain the rate of growth in this program, and we cannot do it all on the backs of the doctors and the hospitals, and the general fund.

We are going to have to do something, but if we are going to have to do something we ought to do something that applies to all of us.

Mrs. JOHNSON. Well, I do want to thank you for your work. Democracy works because there is an enormous reservoir of good sense in the citizenry, and you have really helped us to tap into that and to be reminded of the possibilities for rational action that are out there, and I thank you.

Mr. ANDREWS [presiding]. Mr. Moody will inquire.

Mr. MOODY. Thank you, and let me join my colleagues in saluting your work. I have enjoyed the sessions that I have attended. I hope you will come to Milwaukee, and I hereby invite you to put that on your itinerary as soon as possible.

I think it would be very helpful. It is a tremendous educational experience to do it because it does force the participants to make the tradeoffs that we, here, in Congress have to make, and as you pointed out correctly, when you ask constituents, on an item by item basis, of course they do not want tax increases, of course they do not want benefit cuts, and the result is it adds up to paralysis because you cannot do all of that at once.

You cannot have cuts in benefits, and at the same time have cuts in taxes.

I was very interested that you only have two scared cows, education and environment. Not narcotics? Drug control was not one of your sacred cows?

Mrs. COX. I wanted to say something when Mr. Rangel was here. There was no option in our exercise to cut money for drugs or the homeless, so it is not fair to say that people would or would not have done that. There were options to cut environmental and education programs, and they would not do it at all.

Mr. MOODY. And those were thumbs down on that. I was intrigued by your revenue proposal. When confronted with tradeoffs, people were prepared to consider raising the top bracket on the income tax rate?

Mrs. Cox. Yes, sir. A very substantial portion of the groups were ready to do the 33 percent rate.

The interesting thing is—and we offered them a wide array of income-tax options, from a surtax to a different alternative minimum tax, to a higher rate for corporations.

And I said in an aside to Mr. Bolling, my sense, having been at those meetings, is that people are tired of changes in the income tax. Their forms change every year, the rules change every year, and they just do not seem very receptive to most changes in the income tax right now.

But the overwhelming majority of the groups would support an explicit top rate of 33 percent.

Mr. Moody. That is interesting. In this building, the perceived wisdom is that it is too early to change the 1986 compact, and so your recommendations are an interesting departure from what we have been hearing.

The other thing that intrigued me on the tax side was the willingness to tax Social Security benefits more like private pension benefits, and let's say 85 percent instead of the 50 percent now.

And you said AARP is one of your active groups. Are they willing to do this? If they were willing to do this, that would be a tremendous step forward to the public dialog.

Mrs. Cox. I do not mean to misrepresent the AARP position—to represent the AARP position. AARP helped pay for this program of exercises around the country. There were members of AARP who participated in these groups.

We also have conducted this exercise with the senior citizen interns programs here, on Capitol Hill, for the last 4 years, and majorities of those groups have been willing to do that.

But to my knowledge, AARP has not taken an affirmative position that they would support that, sir.

Mr. Moody. It seems to me that would make a lot of sense because we would only be asking recipients of Social Security, who really were fairly comfortable, to pay something.

Those who were at a modest income level would pay nothing, or hardly anything, and that is, I think, much more attractive than freezing COLA's because COLA's, at the bottom end of the income spectrum, hurt proportionally more than suspending COLA's at the top end of the income spectrum.

Did you say that people would adopt COLA freezes for the short-term, and taxation of pension benefits for the longer term?

Mrs. Cox. It appears that when driven to find short-term large amounts of savings, that in addition to changing the tax treatment of benefits people are willing to accept some kind of one-time freeze on COLA's.

There does not appear to be much support for permanently changing the formula you use to compute your COLA's.

Mr. Moody. Fine. One last question.

When you get your targets, what was the proportion of the mix between spending cuts and revenue increases? Is it 2 for 1, 1 for 1, or 1 for 2? Do you have a ratio?

Mrs. Cox. It varied, as you would expect it to, in a 40–60 range. You had some groups that produced as much as 60 percent of their deficit reduction on the spending side, and some that produced as much as 60 percent of their deficit reduction on the revenue side.

Obviously there were groups at the extremes of both of that, but most of the groups fell in that 60-40 range some place.

Mr. MOODY. Right. So revenues were a significant part of almost every package?

Mrs. COX. Yes, sir.

Mr. MOODY. So the public, if this is a reasonable sample of people, reasonable citizens who have to make tradeoffs, as opposed to up or down votes on one item or another—the public appears to be ready to contemplate taxes as a way of getting from here to there. Is that fair to say?

Mrs. COX. Yes, sir. It is also fair to point out they were working off the CBO baseline which means they had very large numbers to come up with to get to budget balance by 1993, and if you talk about a 60-40 mix, even with 50, 60, $70 billion in spending cuts, you still have a big revenue hit you have to get if you are going to get to budget balance.

Mr. MOODY. Thanks very much.

Mr. RHODES. Mr. Moody, I was at two of these, and actually, it was with a table, and it was interesting to me that the sense of priority really was to try to cut first, and if you get to a point where you just do not feel that you can cut any more on programs that are vital, and the like, only then do you go to the revenue side.

But Mrs. Cox is absolutely correct. When you get to the point where you have not balanced the budget—and after all, that is what you are supposed to do—and you cannot cut any more, then you do go to considering enhancement of revenue, and they do.

Mr. ANDREWS. Thank you very, much, Congressman Rhodes and Congressman Bolling. We appreciate your testimony this afternoon.

Chairman ROSTENKOWSKI. And I say this, my good former colleagues, with all due respect to the membership on the other side.

It's amazing, John, President Ford's representative was here yesterday, and in our dialog there is no question about the fact that President Ford is of the opinion that revenues have to be part of a package with respect to deficit reduction.

You, former minority leader, recognize that revenues should be a part and that the people are willing to accept this.

In the last campaign, the commitment was made that no revenues will increased. The very same day that President Bush says we will not raise revenue, the polls are taken and 67 percent of the American people tell us that we are going to raise revenues.

What is concerning me is when will our candidates—when will we catch up to the American people?

Now, evidently the Mondale debacle at the convention has so burdened us as candidates that we are almost frightened beyond belief when revenue questions are asked, when people suggest that we are going to raise them. I just cannot understand why we feel so shy about asking people to shoulder their responsibility.

And John and Dick, Americans are fair-minded people. If you present a package as you suggest where everybody gets the sting just a little bit, that one person or one group of people is not being taken advantage over the next group, they respond.

And I just do not know how to convey that, not only to the administration, but to my colleagues.

Now, I have been out in front on suggesting that revenues are necessary. I have even in the consumer area gotten specific about one item. Abused a little bit, but not so much that I think people want to revolt. It is hard for people to feel that they are paying their dues but seeing waste. And I think that that is the ingredient that we in government have an obligation to educate people into understanding we do not want to waste their tax dollar, either.

Mr. RHODES. Mr. Chairman, may I comment?

There is so much fear here on Capitol Hill. It is almost irrational. I saw it happening when I was here, and it began to increase. It did not used to be here to that extent.

But, let me remind you of the election of 1980 when the word was that Republicans, if they were elected, were going to do away with Social Security. Well, that scared Republicans to death. And on the other side of the coin, there have been accusations against Democrats that were politically bad and certainly not really in accordance with the facts anymore than the Social Security thing was.

And I guess what I—and I know that I am a dreamer, I know that—but I would hope that it would be possible for the members of the House and the Senate of both sides to say that there are certain areas where we are going to defend each other politically. I wish we could do that.

Chairman ROSTENKOWSKI. Boy John, the day that that returns I want to re-up.

Mr. BOLLING. Well, I do too. I would come back were you to do that. That might scare everybody.

But, really, the priority of getting a balanced budget is so obvious, it is so apparent that this is exactly where we have got to go that I would hope that we could get a consensus and that the Members of the House and Senate would stand together and say it is not "He did not do it, He did not do it, I did it," and we all stand together.

That is a dream, but it ought to happen for the good of the country.

Chairman ROSTENKOWSKI. I want to join my colleagues, I am sure Mr. Bolling——

Mr. BOLLING. Mr. Chairman, I would like to say that it would not be the first time that the Congress found the way to give the President a face-saver.

Chairman ROSTENKOWSKI. I agree. I agree.

I want to join my colleague, Mr. Andrews, in thanking you very much for joining us this afternoon.

Mr. RHODES. Mr. Chairman, I asked permission earlier to include a matter in the record, and I think permission was granted to do that.

Chairman ROSTENKOWSKI. Thank you. It will be, without objection.

Mr. RHODES. Thank you.

Chairman ROSTENKOWSKI. Mr. Woodside.

Welcome to the committee, Mr. Woodside. I know that we have some time constraints that you have other appointments that I want you to know how much we appreciate the fact that you have joined us this afternoon, and I am terribly sorry that we are not going to be able to spend more time with you, but I would like for you to spend 5 minutes with us. Give us the benefit of your observations, and we will include everything in your statement in the record, and then we will allow you to take your leave.

Thank you.

STATEMENT OF WILLIAM S. WOODSIDE, CHAIRMAN OF THE BOARD, SKY CHEFS, INC., AND VICE CHAIRMAN OF THE BOARD OF TRUSTEES, THE COMMITTEE FOR ECONOMIC DEVELOPMENT, ACCOMPANIED BY WILLIAM J. BEEMAN, PH.D., VICE PRESIDENT AND DIRECTOR OF MACROECONOMIC STUDIES

Mr. WOODSIDE. Thank you, Mr. Chairman.

I am sure the committee has received copies of both the CED's report, Investing in America's Future, and copies of my remarks. I would like, therefore, to move very quickly into a rather super executive summary, if you will, that touches on, not necessarily all the key points, but why I think our testimony is somewhat different than those presented by other business groups.

We start the same way with a discussion of the budget deficit. We also talk with equal weight about the trade deficit and about our inadequate productivity.

But, we also go well beyond that, and the difference is that we strongly support the notion that in order to move this nation forward we believe that significant new investments are required in human resources, in the infrastructure of the United States, and in research expenditures by both the public and the private sectors.

And we are also trying to be realistic, and recognize that to reduce the Federal budget deficit it will most likely be necessary both to decrease many current Federal expenditures, including entitlements—and I will get to those in just a second—and also to increase taxes.

In addition, we believe the budget process has a strong bias for insupportably realistic projections for the future, and we think that is the case right at the moment. We are also very much concerned about the fact that our ability to reverse the trade deficit and budget deficits is constrained by inadequate domestic investment.

But let me talk generally about our proposal and then specifically on two very touchy issues, entitlements and new programs.

To eliminate the budget deficit, we strongly recommend that we aim for a combined annual spending cut and tax increase of about $40 billion, which at that rate, will take us 4 or 5 years to bring the budget deficit to near zero.

In the spending area we recommend a reduction in real defense spending accompanied by an increased insistence on burden sharing by our allies commensurate with our changing national security needs and Russia's changing attitude.

We also recommend that with regard to tax increases is that they be designed so that they do not deter research, growth, and productive investments. The CED has no particular position on what type of tax should be adopted. At the moment a special CED committee is wrestling as hard as everybody else is on how to raise the needed additional revenue.

Now, let me return to that delicate subject of Entitlements.

We all know they simply must be better controlled in any effective deficit reduction package. It is not comfortable to talk about, but we think there are a number of substantial and equitable savings that can be achieved through Social Security changes.

Gradually raise the normal retirement age for Social Security from 65 to 68, but phasing it in more rapidly than the present law. And in addition, the early retirement age should be raised in stages to age 65.

Now, it is ironic, this age 65 which is so sacrosanct across the United States, was set as part of the German Federation that took place under Bismarck in 1870. Since then, medicine, nutrition, and environment have added well over 10 healthy years to the average American, yet we mechanically and unrealistically cling to the age 65 yard stick.

It is time for us to look at that again.

We think we should eliminate the annual income threshold below which Social Security benefits are not taxed, and continue to include 50 percent of Social Security benefits and taxable income.

On this last recommendation I go along with the previous group. I would personally favor taxing 85 percent of Social Security benefits because of the fact that most all tax payers receive much more in benefits than they now contribute.

Now, these additional taxes would not be paid by the poor who live primarily on their Social Security checks, and whose taxable income would fall far below the bottom bracket of the present income tax structure.

As a matter of fact, the Congressional Budget Office as you know has estimated that under the provisions of tax reform, 46 percent of recipient households would not have to pay a tax, even with the changes I have talked about.

Now, these changes are important because it they are all made, including my personal recommendation of going to 85 percent of Social Security benefits, they would reduce the Federal deficit by approximately $20 billion a year. So, we are not talking about small change.

Now, what we consider to be high priority spending needs.

We think that these needs are so important to our future that they ought to be accommodated within the overall reduction target cited above.

CED over the last 6 years has done an enormous number of studies dealing with everything from education, labor policy, health care, retirement, and other social programs.

Let me talk just directly about those that deal with economic performance.

We think that the most important unspent spending need is for investment in human beings, in people. Our ability to remain competitive in the world economy depends heavily on the quality of people who operate out plants and equipment, develop new technology, and manage our nation's business.

We have produced two very effective, we think, reports dealing with education reform, one in 1985 and one in 1987. We have made well over 100 separate recommendations as parts of those reports. I will not go into them at this stage of the game but to say that teacher compensation, educational research, upgrading middle schools, and extension of the school year are key priority areas.

We are also very strong supporters of Head Start and chapter I. As a matter of fact I was down here the day before the Inauguration along with the chairman of CED and the chairman of the National Alliance of Business, John Clendenon, to make arguments in favor of very strong Head Start funding with matching grants from States and an expansion of chapter I dealing with disadvantaged kids.

We know this is expensive. We think, basically, it is a combination of Federal, State, and local funding for this purpose with the bulk of it coming from the State and local governments.

Now, we are, again, not naive. We think that this has to be made in spite of the deficit reduction. This means it has to be funded by reallocating resources in the Federal budget or through new taxes. We are not kidding ourselves about that.

One of the other areas that we think is very important is the assistance in training for those who have been permanently laid off of their jobs. Unemployment insurance does not begin to tackle what is basically a structural issue.

Originally, we recommended the establishment of a dislocated worker program and that has been enacted. Unfortunately, it has been funded well below the level which both the Reagan administration and the Congress had agreed to. And yet it is very important and for relatively small amounts of money, and we think it can have big payoffs.

Technological development begins with the creation of new knowledge and new ideas, and so we think we should adopt a major national objective of consistently supporting high-level basic research, primarily in universities.

And last, I think we are all conscious that our nation's infrastructure, highways, bridges, airports, harbors, and the like are collapsing around us. We believe that the Federal Government ought to begin by developing a well-researched assessment of national needs and capital investments so that we can carefully define priorities and identify the portion of new costs which should be financed by the Federal, State, and local governments and the private sector.

Now, as a CED trustee and vice chairman, I am sure that practically everything I have said today as been cited piecemeal by others in previous forms. But I think there are two special supplemental values in our presentation today.

First, we have tried to present a comprehensive integrated plan that is neither self-serving nor single issue in nature.

And second, the CED membership represents a very large heterogeneous cross-section of corporate America. Our trustees are individually and severally among the most experienced senior and informed members of the private sector. We hope that the CED's comments will be helpful to you in your deliberations.

Thank you, very much, Mr. Chairman.

[The information of William S. Woodside follows:]

TESTIMONY OF WILLIAM S. WOODSIDE
CHAIRMAN OF THE BOARD SKY CHEFS, INC. AND
VICE CHAIRMAN OF THE BOARD OF TRUSTEES
THE COMMITTEE FOR ECONOMIC DEVELOPMENT

MR. CHAIRMAN:

My name is William S. Woodside, and I am Vice Chairman of the Board of Trustees of the Committee for Economic Development. As you may know, the CED, founded in 1942, is now an organization of over 275 of the nation's top corporate executives and a number of presidents of universities who personally involve themselves in the development of CED's policy positions.

The CED's recent comprehensive policy statement entitled, Investing in America's Future, presents the trustees' perspective on what we believe are the most critical economic problems facing the nation and what should be done about them. We will leave copies here for you. Our message today is straightforward. It contains five points.

Point one: We believe the most serious economic challenges facing the nation are the huge fiscal deficit, the equally large trade deficit, and our inadequate productivity growth in a highly competitive global economy.

Point two: The federal deficit has very frequently been understated by optimistic erroneous forecasts; its future burden has been understated by treating the temporary surplus in Social Security funds as if it was operating revenue, when we all know that these Social Security funds will be desperately needed to cover a demographic boom in retirees by the end of this century.

Point three: These twin deficits should and can be very much reduced through firm leadership, political candor, and bi-partisan cooperation.

Point four: We also believe that significant new investments are required in human resources, infrastructure, and research by both the public and private sectors. The education of today's youngsters is particularly inadequate and harmful to our future status as the world's leading economy. These new investments are necessary to avoid further erosion in our relative position, and to fully realize an ever-improving quality of life that should be attainable in our society.

Point five: To accomplish these important objectives, it will most likely be necessary to both decrease many current federal expenditures — including entitlements — and to also increase taxes. Any tax increases should be structured to discourage consumption, to encourage savings, and to encourage investments in a more productivity capacity.

DEFICITS DO MATTER

Let me expand on these points. Some are now saying that our huge twin deficits do not matter, and that some recent favorable changes in trends signal self-correction of our budget and trade deficits. We disagree on both counts. We believe the present forecasts are unsupportably optimistic, as has been most budget forecasts in the past 20 years.

Since 1980, 3/4 of our national gross savings — over a trillion dollars — has been "used up" or diverted by huge U.S. Treasury borrowings to cover the continued federal deficits.

Our debt per capita has recently grown from less than $4,000 to nearly $10,500, and is expected to further grow to $15,000 per capita by 1992. Had we invested much of these borrowed funds to better our future, instead of using them to finance government consumption, one might make an acceptable case for such federal borrowing. But we did not do so. Because we used these borrowed funds chiefly for consumption rather than for productive investment, we have not laid a sound enough basis for increasing our future standard of living and our future competitive position. This was a serious mistake. We must now reduce such consumption-oriented government borrowing.

The development of global financial markets during this period helped support and even encourage our profligacy. We were able to borrow heavily from abroad, at relatively low interest rates, to finance both our federal deficit and the increased consumed imports that have led to our trade deficit.

We now have built up net foreign debt of over $400 billion, which is growing by $130 billion per year. We have deteriorated from being the world's largest creditor nation to the world's largest debtor in just a few short years. Our ability to reverse the trade deficit is constrained by inadequate domestic investment in research and productivity.

Under a best case scenario, i.e., balancing our trade by 1993, we will still owe approximately $1 trillion abroad. Just servicing that debt would require us to run an annual export surplus of $60-100 billion. Servicing that debt, plus also reducing the annual trade deficit from its present high level, will obviously reduce the resources available for much needed investments in our future competitiveness and future quality of life.

In addition, our heavy dependence on foreign capital is dangerous and unreliable. A rapid recall of liquid debt by foreign creditors would have disastrous consequences. Such recall can be easily triggered by foreign political problems, economic pressures, currency fluctuations, or higher foreign interest rates.

Furthermore, the implications of such dependency go far beyond the economic consequences. History gives us no reason for confidence that a long-term debtor nation can also endure as a political, moral or military leader.

A CED PROPOSAL

In our report released last July, Investing in America, we urged Congress and the Administration to adopt a package of fair, credible, and enduring deficit cuts and revenue enhancements to bring the federal budget into balance by 1992.

To eliminate the budget deficit we recommended the following actions:

1. Aim for combined annual spending cuts and tax increases of about $40 billion, until these annual steps bring the budget deficit to near-zero.

2. Restrict federal spending across a broad base of line items, not excessively concentrated in a few areas. Spending curtailment should extend to our major entitlement programs such as Social Security benefits for the non-poor.

3. Do not further cut means-tested federal spending that benefit the poor. We do not preclude savings from increased efficiencies in administering means-tested programs.

4. Further cut real defense spending, accompanied by an increased insistence on burden sharing by our allies, commensurate with our changing national security needs and Russia's changing situation. We believe that significant further cost-saving defense efficiencies can be attained, within the context of an effective and viable structure and stragegy.

5. Adopt some tax increases to help cut the deficit, if this is necessary. Such increases should be designed so that they do not deter research, growth, and productive investments.

The CED has not yet specified what kind of tax increases should be considered. The Committee is attempting to do so in a special tax subcommittee that is now underway.

DEALING WITH ENTITLEMENTS

What I have just described is CED's broad program for a return to U.S. fiscal responsibility. Now, let me be more explicit about one controversial area in this package, where spending needs to be controlled.

I refer, of course, to entitlement outlays. They are such a large percentage of the budget, and are rising so fast, that they simply must be better controlled in any effective deficit reduction package. Difficulty does arise from the issue of fairness and the social contract.

Let me give you some examples of how we believe substantial and equitable savings can be achieved through Social Security changes:

1. Gradually raise the normal retirement age for Social Security from sixty-five to sixty-eight, and phasing this increase in more rapidly than current law provides. In addition, the early retirement age should be raised in stages to 65.

   This change would also ameliorate the demographic problem of a shrinking workforce that will confront us in the next century, as we have more people over 65 than under 18. Age 65 was selected as an appropriate retirement date in 1870, by Bismarck. Since then, medicine, nutrition, and environment have added well over ten healthy years to the average American, yet we mechanically cling to the age 65 yardstick.

2. Use the lesser of the annual increase in average wage or in the CPI, to calculate automatic inflation adjustments in Social Security benefits.

3. Eliminate the annual income threshold below which Social Security benefits are not taxed (currently these are $25,000 for a single return and $32,000 for a joint return), and continue to include 50% of Social Security benefits in taxable income. On this last recommendation I would personally favor taxing 85% of Social Security benefits because taxpayers receive much more in benefits than they now contribute.

These additional taxes would be paid by middle and higher-income individuals, but not by the poor who live primarily on their Social Security checks, and whose taxable income in virtually all cases would fall below the bottom bracket of the present income tax structure. CBO has estimated that under the provisions of tax reform 46% of recipient households would not have to pay a tax even with these changes.

If all these Social Security changes were made (including taxing 85% of Social Security benefits) they would reduce the federal deficit by over $20 billion per year.

HIGH-PRIORITY SPENDING NEEDS

While we recommend this rigorous program for overall budget deficit reduction, we also recognize that certain additional spending needs are so important to our future that they ought to be accommodated within the overall reduction targets cited above.

During the past several years, the CED has done major studies on education, labor policy, health care, retirement and other social programs, and within some of those areas we have found compelling needs for new resources coupled with both public and corporate policy changes. Even the limited role we recommended for the federal government in these cases will not be filled without more resources and reallocation.

Let me talk about three of those that are directly related to our economic performance. CED believes the most important unmet spending need is for investment in human capital. Our ability to remain competitive in the global economy depends heavily on the quality of the people who operate our plants and equipment, develop new technology and manage our nation's businesses. Six years of research by two CED subcommittees regarding the relationship of human capital to U.S. productivity resulted in the following conclusions:

- the nation's high schools are producing an alarming number of graduates who qualitatively fall far short of what business and the nation needs to remain competitive and to sustain our standard of living;
- an increasing proportion of students is not even making it through high school. In some urban school districts, 75% of black males do not finish high school;
- a great many of the nation's schools suffer from poor management and from a declining number of committed and competent teachers and administrators. Most of today's new teachers have below average scholastic achievement scores;
- students in many of today's schools, rather than developing good work habits and high standards of behaviour (such as self-discipline, reliability, honesty, and perseverance), find themselves in decaying buildings, where they are enticed by drugs, ridiculed by their peers for any success, while authority is disregarded.

In sum, we have a system of elementary and secondary education that produces too much school failure — at huge social costs in crime and in foregone earnings by these poorly equipped students.

In our first study on education reform, Investing in our Children, we made 89 separate recommendations covering curriculum redesign, standard-setting, parental responsibility, school management and so on. We also devoted considerable attention to looking at where new investments in our schools were really needed. We determined that the following areas deserve priority attention: teacher compensation, educational research, upgrading the middle schools, and extension of the school year.

Finally, we advocated a strong pre-school program for disadvantaged children. We became convinced that by far the greatest return on society's investment would come from improving the education quality and opportunity in the beginning years. For example, twenty years of longitudinal research has shown that one year of high-quality pre-school programming at the age of 4 would return as much as $6 for every $1 invested.

In our subsequent study, Children in Need, we discovered similar investments with like payoffs, including: good prenatal care, child immunization, prenatal food supplement programs and prenatal counseling. We also recommended that this investment be aimed primarily at the educationally and economically disadvantaged children in our nation, where 1 in 4 children under the age of 6 live in poverty. Without help, the majority of these children are virtually guaranteed to fail school.

We estimate that a new program of such investments for each eligible child in poverty will cost over $11.5 billion annually. This is an investment we strongly believe needs to be made. We have recommended a combination of federal, state, and local funding for this purpose; mostly below the federal level. Specifically on the federal level, we have recommended full funding to upgrade the Head Start Program and Chapter I, which is now directed to meet the needs of poor children in elementary schools. We have urged that this investment be made despite the need for federal deficit reduction, an investment that inevitably will have to be funded by reallocating resources in the federal budget or through new taxes.

A second area in which CED believes additional resources are a high priority is in assistance and training for those who have been permanently laid off from their jobs. They desperately need help to obtain new employment opportunities. In our study, Work and Change: Labor Market Adjustment Policies in a Competitive World, we recommended the establishment of a dislocated worker program, which has been enacted. Unfortunately, this well-designed program has been funded way below the level which both the Reagan Administration and the Congress had agreed to. And it is likely to continue to be underfunded as long as we face our current deficit crisis. Yet the expenditure of comparatively few more dollars spent in the right spots can yield invaluable dividends in regained worker productivity.

A third area deserving high-priority attention is our technological progress. Technological development begins with the creation of new knowledge and new ideas, often through basic research. Though private industry, foundations, universities and state governments have been and should be important sources of research funds, there is no realistic alternative to the federal government as one primary source of funds for basic research. Accordingly, we believe the federal government should adopt a major national objective of consistently supporting high level basic research, primarily in universities. This will maintain a strong foundation of knowledge to underpin our further economic growth and industrial innovation.

Finally, we believe greater attention needs to be made to upgrade primary portions of our nation's infrastructure — highways, bridges, airports, harbors and the like. It is well recognized that much of our nation's infrastructure is in disrepair and needs considerable reinvestment. CED has not recommended specific budget figures nor outlined a specific federal role. We believe the federal government ought to begin by developing a well-researched assessment of national needs and capital investments. This assessment should carefully define priorities, and should specify the portion of new costs that should be financed by the federal, state and local governments and the private sector.

In closing, CED believes that our budget deficits must be eliminated. Within that austere context, we must also reallocate more resources to those investments which preserve our future economic strength. Consuming more than we produce has got to stop. It will never be cheaper to do so than it is now.

As a CED trustee, I expect that much of what I have said today has been cited piecemeal by others in previous forums. It would be hard to conjure up a comment that has not already been written about the size and consequences of our twin deficits. If so, I think there nonetheless are two special, supplemental values in our presentation today.

First, we have tried to present a comprehensive, integrated plan that is neither self-serving nor single issue in nature.

Second, the CED membership represents a very large, heterogeneous cross-section of corporate America. Our trustees are individually and severally among the most experienced, senior, and informed members of the private sector.

We hope that the CED's comments will be helpful to you.

INVESTING IN AMERICA'S FUTURE

CHALLENGES AND OPPORTUNITIES FOR PUBLIC SECTOR ECONOMIC POLICIES

CED

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RESPONSIBILITY FOR CED STATEMENTS ON NATIONAL POLICY

The Committee for Economic Development is an independent research and educational organization of over two hundred business executives and educators. CED is nonprofit, nonpartisan, and nonpolitical. Its purpose is to propose policies that will help to bring about steady economic growth at high employment and reasonably stable prices, increase productivity and living standards, provide greater and more equal opportunity for every citizen, and improve the quality of life for all. A more complete description of CED appears on page 39.

All CED policy recommendations must have the approval of trustees on the Research and Policy Committee. This committee is directed under the bylaws to "initiate studies into the principles of business policy and of public policy which will foster the full contribution by industry and commerce to the attainment and maintenance" of the objectives stated above. The bylaws emphasize that "all research is to be thoroughly objective in character, and the approach in each instance is to be from the standpoint of the general welfare and not from that of any special political or economic group." The committee is aided by a Research Advisory Board of leading social scientists and by a small permanent professional staff.

The Research and Policy Committee does not attempt to pass judgment on any pending specific legislative proposals; its purpose is to urge careful consideration of the objectives set forth in this statement and of the best means of accomplishing those objectives.

Each statement is preceded by extensive discussions, meetings, and exchange of memoranda. The research is undertaken by a subcommittee, assisted by advisors chosen for their competence in the field under study. The members and advisors of the subcommittee that prepared this statement are listed on page vi.

The full Research and Policy Committee participates in the drafting of recommendations. Likewise, the trustees on the drafting subcommittee vote to approve or disapprove a policy statement, and they share with the Research and Policy Committee the privilege of submitting individual comments for publication, as noted on page 37 of this statement.

Except for the members of the Research and Policy Committee and the responsible subcommittee, the recommendations presented herein are not necessarily endorsed by other trustees or by the advisors, contributors, staff members, or others associated with CED.

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*Voted to approve the policy statement but submitted memoranda of comment, reservation, or dissent. (See page 37.)

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*For purposes of this study, the CED Program Committee, expanded to include several other Trustees, served as the Subcommittee.

FOREWORD

WHERE CED STANDS

This statement presents CED's perspective on what we believe are the most critical economic problems facing the nation and what we think should be done about them. Investing in America's Future differs from other CED policy statements in that it is an updated distillation of conclusions and recommendations drawn from recent in-depth CED studies of current issues.

It is intended as a guide for all individuals and organizations interested in sorting out the crucial economic issues affecting the health of this nation. It indicates clearly where CED stands on the major economic issues that have emerged in the current political campaign.

In the course of political campaigns, issues can become clouded and economic priorities confused. Therefore, it is critical not to lose sight of the fundamental public issues that have to be dealt with no matter what the electoral outcome. The sooner candidates and the voters focus on these issues, the more effective the political process will be in dealing with them.

The special value of this statement is that it offers policy makers and citizens an integrated approach to key national economic issues. Drawing on over a dozen CED studies, it succinctly outlines what we believe are the economic issues most in need of public action.

While Investing in America's Future summarizes the analysis contained in the source statements, the documentation presented here is not meant to be complete or comprehensive. The full research and reasoning that supports CED's policy positions can be found in the statements that have formed the basis of this report. These source statements include:

Toll of the Twin Deficits, 1987

Finance and Third World Economic Growth, 1987

United States-Japan Trade Relations: A Critical Juncture, 1987

Work and Change: Labor Market Adjustment Policies in a Competitive World, 1987

Children in Need: Investment Strategies for the Educationally Disadvantaged, 1987

Reforming Health Care: A Market Prescription, 1987

Leadership for Dynamic State Economies, 1986

Tax Reform for a Productive Economy, 1985

Investing in Our Children: Business and the Public Schools, 1985

Fighting Federal Deficits: The Time for Hard Choices, 1984

Strategy for U.S. Industrial Competitiveness, 1984

Productivity Policy: Key to the Nation's Economic Future, 1983

Strengthening the Federal Budget Process: A Requirement for Effective Fiscal Control, 1983

Public-Private Partnership: An Opportunity for Urban Communities, 1982

Jobs for the Hard-to-Employ: New Directions for a Public-Private Partnership, 1978

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I would like to thank the members of the CED Program Committee who, along with other trustees, provided the leadership necessary to establish these priorities and set these goals. Very special thanks should also go to William F. May, former chairman of the Research and Policy Committee, under whose chairmanship this statement was prepared.

We are also deeply indebted to William J. Beeman, CED's vice president and director of macroeconomic studies and project director for Investing in America's Future, for his enlightened and insightful approach to these very difficult issues.

We also gratefully acknowledge the Ameritech Foundation and the CIGNA Corporation for their generous support which has permitted CED to expand substantially distribution of this important statement.

Dean P. Phypers
Chairman
Research and Policy Committee

Chapter 1

INTRODUCTION

Mixed signals are flashing for the U.S. economy. We have enjoyed the benefits of the longest-running expansion in the post-World War II era, several years of reduced inflation, and a high level of employment. We now have the opportunity to enjoy even greater prosperity in the future if the makers of public policy have the resolve to adopt and carry out certain basic economic reforms that can ensure major long-run benefits to our society. If we do not take this opportunity, however, our future economic progress and our nation's leadership position in the world may be threatened.

The most obvious economic challenges facing U.S. policy makers today are the federal budget deficit, the huge trade deficit, and weak growth in productivity relative to many other advanced industrial countries. But there are several other endemic problems that should be addressed, including a growing underclass of poorly educated and socially troubled individuals, disappointing educational quality in the public schools, and the gap between the promise and the delivery of adequate and affordable health care. These are tough and basic problems, and although many have already received some attention, progress to date has been far from adequate.

There is a tendency to look for a single specific overriding cause for these economic problems, be it an American society that is living beyond its means, unfair trade practices by our foreign competitors, or a decline in the American work ethic. Yet, in reality, both the causes of these problems and the actions needed to correct them are numerous, interrelated, and complex. Nevertheless, the solutions are achievable providing we develop the will to forgo some immediate consumption and invest more heavily in human and physical capital in order to encourage future economic growth.

This statement presents CED's perspective on the most important economic problems facing the nation, concentrating on those that can be addressed through public policy actions. We recognize that several other important issues that policy makers need to address promptly, such as the problems of drugs, crime, and housing, are not covered. We have confined our comments to the top-priority economic and social concerns that CED has been studying for several years; progress toward their solution will also provide resources needed to tackle other critical issues.

The conclusions presented in this statement draw from recent CED research on a wide range of issues. CED's Trustees have developed a body of recommendations designed to improve the fundamental health of the U.S. economy and to help policy makers rethink strategies in a new global context.

The policy decisions that we make as a nation in the next several years will determine the course that this country takes well into the next century. Economic policy decisions need to focus more clearly on the long-run benefits for society. They also need to reflect a much clearer understanding that the nation is functioning in an increasingly global economy. If we fail to adjust to the changes in the world around us, we simply will not take those actions necessary to provide for continued growth, prosperity, and an increasing standard of living.

The incoming Administration and Congress should view their first months in office as an opportunity to assess the challenges facing the nation and to break free of the rigid partisanship that is handicapping effective action. The United States can neither effectively deal with its economic problems nor retain its world leadership unless it musters the political will to put its economic house in order.

This can be done if policy makers begin now to take the following actions:

- Identify Critical Problems. In this statement, we identify the most pressing economic problems facing the nation and single out those areas of economic policy in which prompt, well-designed public-sector action is most critical.

- Set Priorities. In our view, the three most important objectives of economic policy today should be: (1) to significantly reduce our budget and trade deficits; (2) to improve productivity growth; and (3) to avoid protectionist policies in international trade both here and abroad. Achieving these basic goals will set the stage for reforms in many other policy areas.

- Assess Solutions. In deciding on courses of action, we need to capitalize on this nation's strengths. Free market solutions should be encouraged wherever possible, and public policy prescriptions should promote investment in the future health of the economy, even when this requires sacrifices. Finally, all actions need to be evaluated in light of the fact that the United States is now inextricably a part of a global, interdependent economy.

This statement proposes ways to deal with both short-term and long-term economic problems. Some of the proposed actions could achieve significant benefits in the near future, perhaps in one to five years. Our recommendation to eliminate the structural budget deficit, for example, would raise national saving, lower capital costs, and improve competitiveness fairly quickly. Other recommendations, especially those involving increased investment in human and physical capital, will take many years to bear fruit. But it is urgent that we act now to improve both the short- and long-run performance of the economy.

Chapter 2 outlines the broader signs of economic distress, including budget and trade imbalances and the macroeconomic causes of lost competitiveness. We recommend a budget policy of both reduced spending and increased revenues, and we outline how monetary policy can facilitate changes in budget policies.

Chapters 3 and 4 deal with the issue of longer-term economic growth. To enhance productivity growth we recommend specific policies in the areas of taxation, technology, regulation, and trade as well as policies to improve human resources in the areas of education, employment, health, retirement, and public welfare.

Chapter 5 addresses the importance of improving, strengthening, and streamlining the public institutions in which decisions are made, and the critical importance of the economic policies of state and local governments. In Chapter 6 we stress the overriding importance of building a constituency and a consensus for action. Practical bipartisan economic progress will come only if the Administration and Congress work out their differences in order to develop and support sound, practical economic programs. Such action needs to be motivated and backed by strong, vocal, and enduring public support. The American public needs to make it very clear that it will support those policy makers who will make the hard choices and follow through with their decisions. Once made, these decisions will bring real benefits. We believe that proper actions taken within the next year will bring the United States increased productivity growth, improved international competitiveness, and an improved quality of life.

Chapter 2

BUDGET AND TRADE DEFICITS

During the 1970s, growth in productivity slowed in the United States and inflation accelerated, reaching a postwar peak at the end of the decade. To counter these adverse economic trends, the thrust of monetary and fiscal policies was dramatically changed in the early 1980s. The Federal Reserve adopted a restrictive monetary policy for a time, and shortly thereafter, federal fiscal policy became very expansive. Federal spending grew rapidly and was accompanied by successive reductions in income taxes. Although monetary policy successfully reduced inflation, fiscal policy failed to achieve its objectives for domestic saving and investment and gave rise to very costly budget and trade deficits.[1]

The decline in the international competitiveness of U.S. industry was so dramatic that in a very few years, the United States went from being the world's largest creditor to the nation with the largest foreign debt. (See "Budget Deficits and U.S. Competitiveness," page 5.)

The huge successive federal budget deficits and the rapid growth in our debt to foreigners have encouraged and sustained the current cyclical economic expansion. But they also have two adverse consequences. First, they place a burden on future generations who will have to service both debts. Future payments of interest and principal to foreigners are particularly burdensome because they will transfer purchasing power abroad. Second, the budget and trade deficits create an increasingly unstable current economic situation both for our country and for the world because of our dependence on foreign saving. We can increase our debt to foreigners so long as we can service it and foreign investors desire to hold more of our debt. But, if foreign investors should seek to reverse these capital inflows, the consequence could be serious for the U.S. economy. Indeed, in 1987, private foreign investors began to lose confidence in the economic policies of the United States, and capital inflows from these sources fell, contributing to the sharp decline in the value of the dollar in international exchange markets. Large-scale intervention in foreign exchange markets by U.S. and foreign central banks stemmed the dollar's decline temporarily. The year-end 1987 budget deficit compromise and continued intervention appear to have eased some concerns and reduced pressures on the dollar. To fully restore investor confidence, however, more fundamental policy changes are needed to eliminate the budget deficit and dependence of the United States on foreign capital.

The dollar's sharp decline has finally begun to improve the competitiveness of U.S. industry, and the trade balance is responding, particularly in real terms. But currency adjustments by themselves take many years to turn around a current-dollar trade deficit and have costly effects on the efficiency of business decisions, on overall price stability, and on living standards. Moreover, reliance on currency adjustments can limit the flexibility of monetary and fiscal policy to deal with changes

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[1] See CED policy statement Toll of the Twin Deficits.

TABLE 1. BASELINE BUDGET PROJECTIONS AND UNDERLYING ASSUMPTIONS

	1988	1989	1990	1991	1992	1993	1994
Budget Projections (By fiscal year)							
In Billions of Dollars[a]							
Revenues	909	983	1,069	1,140	1,209	1,280	1,359
Outlays	1,064	1,142	1,215	1,287	1,348	1,416	1,489
Deficit	155	159	146	146	140	135	130
Deficit Targets[b]	144	136	100	64	28	0	--

BUDGET DEFICITS AND U.S. COMPETITIVENESS

At the beginning of the 1980s, the Federal Reserve adopted a restrictive monetary policy that succeeded in sharply reducing inflation. Tight credit conditions brought about the 1981-1982 recession, which broke the back of inflationary expectations. Federal fiscal policy, on the other hand, moved in an expansive direction. Taxes were cut in stages, beginning in 1981, in an attempt to encourage private saving and investment, with the ultimate objective of achieving improved growth in productivity. The tax burden declined sharply for both individuals and corporations, and the total revenues fell from 20.1 percent of the gross national product in fiscal 1981 to 18.5 percent in fiscal 1986. However, tax cuts were not successfully tied to overall spending restraint. Total outlays continued to rise as a percentage of GNP, and the budget deficit rose to record peacetime levels. Large cuts were made in nondefense discretionary spending, which declined from 5.6 to 4.1 percent of GNP; but these cuts were more than offset by the continued growth in entitlement programs and the very large increases in spending for national defense and for interest costs on the debt.

Unfortunately, the shift in tax policy has not succeeded so far in boosting private saving and investment rates. National saving (public and private) has been very weak, and large saving inflows from abroad have been necessary to prevent investment spending from collapsing.

Indeed, budget imbalances and capital inflows were the major cause of the precipitous decline in the international competitiveness of American industry in the 1981-1986 period.[a] Long-run forces, such as low private saving, had been gradually eroding the international competitiveness of U.S. industry for many years. Despite some improvement in long-run factors in the 1980s, our competitiveness position in the world was suddenly devastated by a very sharp rise in the dollar. U.S. macroeconomic policies caused real interest rates to rise relative to those abroad, and as a consequence of those yields and the relative safety of investment in the United States, foreign demand strengthened for dollars to invest here. As the dollar rose, domestic production became less competitive, and our trade balance plunged. In a very short time, the United States went from being the world's largest creditor to the world's largest debtor.

Policy makers did not anticipate this outcome. Past experience indicated that the absorption of private saving by the federal sector would crowd out private investment as the economy approached the full utilization of resources. However, the degree of international economic interdependence was underestimated. The strength of foreign saving inflows, which sustained the growth of domestic investment, albeit at a moderate rate, was not expected. Instead of hurting domestic investment, the budget deficit drove the dollar higher and crowded out some of the domestic production of goods and services that compete in international markets.

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[a] CED estimated that about two-thirds of the rise in the U.S. trade deficit from 1981 to 1986 was caused by U.S. macroeconomic policies. For a description of the other major forces causing this decline, see Toll of the Twin Deficits, Chapter 4.

in the economic environment. To limit these costs and safeguard our future, we need to attack the fundamental causes of the trade deficit.

We need a sound strategy to deal with the economic imbalances threatening both the short-run stability and the long-run growth of the economy. The number-one priority must be to eliminate the structural component of the huge federal budget deficit. For many years, CED has advocated a long-term policy of a federal budget in surplus or at least in balance when the economy is at high employment levels. Given that the economy is now operating near the economists' definition of high employment, it is obvious that we have a long way to go to achieve even minimum standards for the structural (or noncyclical) component of the deficit. But we cannot reach our long-term budget objectives all at once. In the policy statement Fighting Federal Deficits: The Time for Hard Choices, CED called for a comprehensive program aimed at reducing the deficit on a steady, year-to-year basis, leading to a balanced budget at high employment over a five-year period.

Congress has adopted deficit targets, and at the Budget Summit held last November the Administration and Congress made some, but not enough, headway toward deficit reduction. Some observers believe that the budget deficit issue is not likely to be resolved satisfactorily without major reforms in the budget process. In CED's view, however, it is a lack of political will rather than any serious deficiencies in the budget process that stand in the way of progress on the budget deficit issue. (See "The Federal Budget Process," pages 8 and 9.)

At the end of 1987, Congress established the National Economic Commission, a bipartisan group of leading citizens charged with finding an efficient and equitable method of reducing the budget deficit. The task is formidable. Congressional reports indicate that the budget policies in place at the end of 1987 are not even sufficient to reach the Gramm-Rudman-Hollings budget targets for the current and next fiscal years.[2] According to the Congressional Budget Office (CBO), if no further policy changes are made, the budget deficit will be about $157 billion in fiscal 1988 and $176 billion in fiscal 1989, well above the deficit targets for those years. The budget deficit would be even larger, if it were not for the projected surpluses in the Social Security trust fund amounting to $37 billion in fiscal 1988 and $46 billion in fiscal 1989.

We believe this situation calls for fundamental changes in federal fiscal policy to eliminate the structural budget deficit. To do otherwise is to tell this generation of Americans it can have a free lunch at the expense of the next. Both spending cuts and tax increases will be necessary. We understand the opposition of some taxpayers to tax hikes. However, opposition to any tax increases implies either (a) that currently projected deficits are acceptable or (b) that nearly one-fifth of federal spending for national defense, nondefense discretionary programs, and entitlements such as Social Security is excessive and can be eliminated. Clearly, substantial cuts in spending must be made and the deficit reduced. But the idea that spending for all such programs should be cut by one-fifth does not reflect the will of the American people or the judgment of CED. Indeed, as we indicate later in this statement, CED believes that in certain critical areas, such as education, the federal government should invest more heavily than it does currently.

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[2] The original Gramm-Rudman-Hollings targets for fiscal 1988 and 1989 were $108 billion and $72 billion, respectively, but these targets were raised in September 1987 to $144 billion and $136 billion.

Given these considerations, we believe the following actions are necessary.

- Congress and the Administration should adopt a package of credible spending cuts and tax increases that would eliminate the structural component of the federal budget deficit over the next four years. This can be achieved by basic and enduring deficit cuts of $40 to $50 billion a year. Deficit-reduction targets should not be fulfilled by one-time savings, asset sales, or smoke-and-mirror devices that do not amount to real cuts in federal credit demands.

- The deficit reduction will have to involve both expenditure restraints and revenue-increasing measures. Restrictions on spending should be broadly based, not excessively concentrated in a few areas. Means-tested federal spending benefiting the poor has been cut enough and should not be cut further for purposes of reducing the deficit. (This does not preclude savings as a result of increased efficiencies in the administering of means-tested programs.) Spending restrictions should extend to entitlement programs such as Social Security benefits for the nonpoor, as well as to discretionary spending.

- Defense spending must be adequate to meet national security needs, and taxes must be sufficient to finance it. If cuts in defense spending are made, they should be accompanied by an increased emphasis both on burden sharing by our allies and on appropriate adjustments in longer-term military programs and objectives. While cost-saving efficiencies in the management of defense expenditures should be continually sought, reductions in military spending should be based on a viable force structure and should be lasting.

- Tax increases to cut the deficit should not deter growth, productive investment, and competitiveness. Moreover, they should be linked to forceful and enduring measures of expenditure curtailment, with clear assurance that the additional revenues generated will, in fact, be devoted to deficit reduction rather than to spending.

Depending on economic conditions, it may be necessary to have an expansive monetary policy to counterbalance the restrictive effects of successive years of declining structural budget deficits. Indeed, a change in the monetary-fiscal policy mix is an appropriate way to reduce real interest rates and assist capital formation so long as it does not lead to excessive inflation.

Both monetary and fiscal authorities need to give much more careful attention to the impact of their policies on the competitiveness of U.S. industry. But changes in U.S. macroeconomic policy by themselves will not be sufficient to achieve an enduring restoration of U.S. competitiveness and a rising standard of living. Both the government and private business must also undertake longer-run measures that encourage more vigorous growth in productivity and improved international competitiveness (see Chapters 3 and 4).

THE FEDERAL BUDGET PROCESS

A strong federal budget process is essential to the effective functioning of the political and economic systems of the United States. However, as delays, political conflicts, and out-of-control deficits have come to characterize the federal budget performance, many have asked whether the process needs a major overhaul. CED's policy statement Strengthening the Federal Budget Process concluded that flaws in the budget process have not been responsible for the large federal budget deficits.

- We believe that the basic elements of the present budget process should be continued. Any structural changes that would weaken the effectiveness of the process should not be enacted.
- Greater recognition should be given to the fact that the lack of political will is both the single greatest cause of the budget deficit and the greatest obstacle to resolving it.

Moreover, important progress has been made in the federal budget process, especially in providing better information on which to base budget choices. At the same time, the process should be strengthened further, particularly to improve information and clarify concepts.

- The comprehensive unified budget concept should be supported. Social Security should not be removed from the unified budget, and activities classified as off-budget should be incorporated in the unified budget.
- Federal credit programs should be subject to most of the budget control procedures used with direct spending.
- We oppose proposals for a separate capital budget that would remove investment-type outlays from the unified budget and allow them to be financed by borrowing in the normal course of events. However, information on investment-type spending should be readily available and capital spending plans should be clearly spelled out (see page 14).
- Individual tax expenditure programs frequently are designed to serve the same purpose as spending programs while avoiding the annual appropriation process.

> Accordingly, tax expenditures should be reviewed jointly with individual spending programs that serve similar purposes, whenever possible.

Certain abuses of the budget process that have become regular practice in the past several years should be eliminated.

- Congress should adopt a strict rule against extraneous legislation being included in reconciliation bills.

- Congress should also create rules that automatically put a continuing resolution into effect at the start of a fiscal year for any account which has not yet received an appropriation and that prohibit inclusion of new provisions in any continuing resolution.

The Gramm-Rudman-Hollings budget procedures, which encourage budget compromise on budget issues and attempt to enforce a specific deficit target, appear to have had some positive effects. But they too have failed to produce a solution to the budget deficit problem. This experience confirms CED's earlier conclusion that the budget deficit is more a question of political will than of procedure.

A controversial proposal to solve the problem is a constitutional amendment of some kind setting out precise budget rules. CED has studied such proposals and has come to a conclusion.

- We oppose a constitutional amendment to require a balanced budget or some other specific limitation on budget outcomes.

Many budget experts contend that proposals for constitutional amendments affecting the budget balance are not likely to be enforced and are easily circumvented and, therefore, may create disrespect for constitutional provisions. Moreover, such proposals either lack sufficient flexibility to adjust to circumstances or involve procedures that are too complex to be included in a basic document such as the U.S. Constitution.

However, increased fiscal discipline is badly needed, and all proposals to achieve it ought to be explored. Given the gravity of the budget deficit, it may be necessary, for example, to place greater reliance on deficit-reducing procedures such as the automatic continuing resolution proposal.

Foreign governments also have an important role to play in reducing the imbalance in world trade.

- The United States should urge countries with large trade surpluses to undertake policies that prudently boost their demand for imports and to reduce barriers to imports.

Finally, the United States and other industrial countries should pursue policies that help restore the economic health of the developing countries.

- Industrial countries should reduce their own barriers to imports from developing countries and should cooperate with multilateral financial institutions and other countries to improve the economic policies and reduce the debt burdens of the developing countries.*

The requirement that LDCs reform economic policies as a condition for receiving additional financial resources channelled through multilateral institutions is at least as important as the resources themselves. Such conditionality can encourage the developing countries to strengthen the private market system and, therefore, enable them to more fully realize the potential for increased production and exports.[3]

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[3] For a detailed discussion of CED's views concerning Third World debt, see Finance and Third World Economic Growth.

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*See memorandum by W. Bruce Thomas, page 37.

Chapter 3

ENCOURAGING PRODUCTIVITY AND ECONOMIC GROWTH: PHYSICAL CAPITAL, TECHNOLOGY, REGULATION, AND TRADE

Although the United States today enjoys a very high standard of living, the rate of growth in our productivity has been weak since the early 1970s and well below that of most other major industrial countries. From 1950 to 1973, productivity in the nonfarm business sector grew at an average annual rate of 2.3 percent; but since that time, productivity growth has averaged only about 0.8 percent. Productivity growth in the manufacturing sector has improved significantly in the 1980s, in part because of plant closings and industrial restructuring, but the overall productivity growth rate is still below its historical trend. Moreover, it has not improved enough to redress the earlier shortfall.

For most of the post-World War II period, U.S. productivity growth has also lagged well behind that of our trading partners. From 1960 to 1986, U.S. manufacturing productivity growth averaged 2.8 percent annually compared to 5.1 percent growth for the other major countries that belong to the Organization of Economic Cooperation and Development. Even in the period from 1980 to 1986, when growth in U.S. manufacturing productivity accelerated to an average annual pace of 3.6 percent, it lagged well behind the 4.2 percent average rate abroad. This relatively poor productivity performance has contributed to the decline in U.S. international competitiveness and the rising U.S. international debt. Lagging productivity growth and the long-run decline in U.S. competitiveness are interrelated, and both trends need to be reversed.

Over the long run, our standard of living depends fundamentally on the quantity and quality of our human resources, on capital investment and natural resources, on advances in technology, and on our efficiency in utilizing these resources to produce and distribute goods and services. The major part of the task of addressing these factors falls on the private sector. But public policy can play an important role by reducing barriers to efficient private-sector decisions, strengthening private-sector incentives to invest and innovate, and encouraging training and advances in knowledge. The key issue addressed in this chapter is how the public sector can contribute to improving the nation's long-run economic growth through policies encouraging investment in physical capital and technological development as well as policies influencing competitive forces at home and abroad.

ENCOURAGING INVESTMENT IN PHYSICAL CAPITAL

Investment in physical capital not only increases the productive power of workers but also provides the opportunity to introduce new technology into the production processes. Compared to other industrial countries, however, the proportion of U.S. output devoted to investment has lagged during much of the post-war period. Although broad definitions of investment that include durable consumer goods and education indicate that the rate of investment spending in the United States is only slightly below average, more conventional definitions of investment, which appear to be more directly related to productivity growth, show a substantially weaker picture in the United States. Virtually all major industrial countries with productivity growth rates that exceed the U.S. rates have substantially higher rates of conventionally defined saving and investment as a percentage of GNP. Moreover, the average age of capital goods in the U.S. industrial sector is higher than in most other large industrial countries. If the United States hopes to raise its investment to anywhere near the rates prevailing in other major industrial countries, it must eliminate the bias against saving and investment that currently exists in many of its economic policies.

Tax Policy

Government tax and spending policies significantly affect national savings. They also influence private saving and investment behavior, though the impact on private saving is generally less certain. In Productivity Policy: Key to the Nation's Economic Future, CED emphasized the importance of saving and investment in promoting U.S. productivity growth. A number of the recommendations made in that statement are relevant in the current situation.

- Disincentives to saving should be removed, and the bias toward consumption created by tax and public-expenditure policies eliminated wherever possible. Steps need to be taken to eliminate distortions that favor investment in types of assets unlikely to yield significant productivity improvements.

Some progress toward that objective was made by changes in U.S. tax policy enacted in the 1980s. The Economic Recovery Tax Act of 1981 reduced income tax rates significantly, and the most recent overhaul of the system, the Tax Reform Act of 1986, further reduced marginal income tax rates and significantly changed the tax structure, mainly by broadening the federal income tax base.

Thus far, however, tax reform has not succeeded in raising the aggregate saving and investment rates significantly. Nor has it succeeded in removing all tax-induced disincentives to saving and investment. Although it lowered statutory corporate tax rates, the 1986 law raises the corporate tax burden by an estimated $120 billion over a five-year period. This is because it eliminated many tax preferences, such as the investment tax credit, as part of an agreement to broaden the tax base in exchange for lower income tax rates.

The higher corporate tax burden incorporated in the 1986 act has important adverse consequences for U.S. competitiveness. Studies of comparative capital costs show the United States already had a higher cost of capital, including higher taxes on capital, than many other advanced industrial countries before the 1986 tax act. These considerations suggest that further tax reform is needed if we are to minimize the deterrents to economic growth and competitiveness arising from the tax-induced bias against saving and investment.*

As noted in Chapter 2, an effective deficit-reduction package will have to include tax increases as well as spending cuts. However, as we make these changes we must keep working to reduce the existing biases in the tax system that discourage saving and investment.

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*See memorandum by Philip L. Smith, page 37.

- In order to minimize deterrents to economic efficiency and growth, new taxes should interfere as little as possible with economic choices made by individuals and institutions.[4]

New taxes should not favor one industry over another, and they should not discourage saving and investment. Such distortions in the tax system should be avoided because they impede economic efficiency and the growth of the economy. Revenue-raising potential is also an important consideration.

- Any tax proposal in the present context needs to be judged in terms of both its impact on reducing the budget deficit and its effectiveness in encouraging saving, investment, and economic growth.*

Government Regulation and the Cost of Capital

Government regulation also has an important bearing on the rate of capital formation. By influencing the rate of return, regulation may divert investment from its most productive uses. By absorbing resources that could otherwise be used for capital investment, business expenditures to comply with regulations relating to environmental protection, health, safety, and similar concerns also raise the cost of new plant and equipment. For some firms, the financial costs of meeting such social regulations are substantial.[5] The benefits derived from these regulations must be balanced against the financial costs.

Whereas properly designed regulation can contribute materially to the quality of life and the welfare of the community, improperly designed regulation can waste resources and impose unnecessary or unintended constraints on economic growth.

- Government social regulations should be subjected to cost-benefit tests on the basis of information that is relevant and reasonably attainable.

- The use of absolute regulatory requirements and direct controls should be avoided wherever possible. Appropriate regulatory goals should be pursued primarily through market-type incentives.

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[4] This policy of tax "neutrality" was endorsed by CED in Tax Reform for a Productive Economy, p. 6.

[5] While costs for individual firms can be high, statistical analysis of the overall regulatory costs seem to argue that the measurable effects of such regulations on productivity growth have not been large. See CED policy statement Productivity Policy: Key to the Nation's Economic Future, p. 38.

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*See memorandum by James Q. Riordan, page 37.

Investment in Infrastructure

Efficient investment in productive infrastructure, such as highways, bridges, airports, harbors, and water distribution systems, also makes an important contribution to long-term economic performance. Although the U.S. infrastructure as a whole is still superior to that of many other major industrial countries, signs of decay are appearing in many places. We cannot underinvest in this type of capital without undermining the performance of the economy.* As we indicated in Strengthening the Federal Budget Process: A Requirement for Effective Fiscal Control, the United States needs a clear accounting of the magnitude of the problem and assignment of responsibility.

- The President should periodically submit a capital-improvements program for the nation based on an assessment of broad national needs. This program should specify the portion of the cost that should be financed by the federal government, state and local governments, and the private sector. In presenting such a program, the

- President should make clear how the federal government's role fits into a comprehensive, long-term national strategy for maintaining and improving the country's infrastructure.

PROMOTING TECHNOLOGICAL DEVELOPMENT

Technological progress enables the economy to produce new or better products as well as existing products at lower cost. Throughout history, new technology has been a fundamental source of economic growth and rising living standards. Some economists attribute between one-third and one-half of the growth of real per capita income in the United States to technological change, a significantly greater contribution than those of capital and labor. Today, the role of technology in the functioning of the economy and in our daily lives is greater than ever before; moreover, that role is increasing.

Technological development depends on the ability of industry, educational institutions, and government to work together to create, apply, and protect technological innovation. CED addressed the issue of technological research and development in three recent policy statements: Stimulating Technological Progress, Productivity Policy: Key to the Nation's Economic Future, and Strategy for U.S. Industrial Competitiveness.

Research and Development

Technological development begins with the creation of new knowledge and new ideas, often through basic research. The government has always been the main source of funds for basic research. Individual firms often have insufficient incentive to invest in basic research because, even when its research is fruitful, a firm may not be able to capture the benefits for itself. In addition, the long lead time generally associated with the returns on basic research makes this use of funds unattractive for many corporations.

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*See memorandum by Donald E. Guinn, page 37.

Although private industry, private foundations, universities, and state governments have also been an important source of research funds, there is no realistic alternative to the federal government as the primary source of funds for basic research.

- The government should adopt as a major national objective a consistently high level of support for basic research, primarily in universities. In the long run, consistent, stable financial support will provide the country with a strong base of knowledge for future economic growth and industrial innovation.

- The federal government should increase its funding of basic research even at the cost of other activities.

Technological development depends on successful commercial application of the results of basic research. However, U.S. industry has not been particularly successful in this regard relative to some of its competitors. In some areas, we lag behind our competitors in translating the fruits of our basic research into marketable technologies and products.

The primary responsibility for improving the commercial application of research falls on private industry. Government's primary role in this field is to see to it that its regulatory and tax policies are designed so as to minimize disincentives to commercial application. Furthermore, in some cases government can stimulate the application of particular research results in areas where it is directly involved with the design and financing of research, such as defense, space exploration, air traffic control, health, environmental control, and agriculture. In addition, government procurement policy in the areas of advanced technology products can be designed to hasten rapid application of government-funded research by industry.*

Intellectual Property Rights

Inadequate protection of intellectual property discourages R&D efforts and undermines technological progress. While protection in the United States through patents, copyrights, and trademarks may be adequate, new technologies and products are being rapidly diffused and the opportunities abroad for counterfeiting and pirating technology are increasing. Unfortunately, some countries provide only minimal levels or limited areas of intellectual property protection.

- The government has a responsibility to work with other industrial countries in dealing with intellectual property and should encourage, where appropriate, the establishment of effective laws to protect property rights in inventions and innovations while avoiding any improper interference in the affairs of other countries. Such laws should include the establishment of effective patent laws in developing countries.

In light of the fast pace of technological change and the rapidly increasing ability of violators to pirate technology, the Administration is pressing for minimum standards of protection in the present round of the

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*See memorandum by John Diebold, page 38.

General Agreement on Tariffs and Trade (GATT) negotiations. The adoption by GATT of an international minimum standard and an enforcement mechanism is much desired.

PROMOTING EFFICIENCY AND COMPETITION

Depending on how regulatory goals are achieved, government regulation can either enhance or impede economic efficiency. The two types of government regulation, economic and social, focus on different objectives. During the past decade or so, we have seen increasing support for deregulation in the economic sphere. Significant scaling back has been achieved in the regulatory apparatus in such industries as transportation, telecommunications, energy, and financial services. In this process, government regulations on prices, entry and exit, and conditions of services have been deregulated with considerable success.[6]

- Government should continue economic deregulation in areas in which effective competition now exists.

Among the economic regulations, antitrust regulation occupies a special place. Historically, U.S. antitrust laws have focused on domestic market conditions. However, the increasing international competition and globalization of markets necessitates a new look at the underlying principles of antitrust laws.

- Policy makers should review current antitrust regulations, particularly in light of increased world competition, and consider modification of any laws that inhibit technological development and productivity growth rather than stimulate competitiveness in the international market.

- Government should not permit antitrust policies or other economic regulations to be used to protect individual firms from market forces when an individual firm or single industry experiences economic difficulty.

A second trend has been the vast expansion of social regulations aimed at achieving broad goals such as the reduction of pollution, the assurance of safe and healthy working conditions, the safety of consumer products, and the availability of equal employment opportunities. This expansion has been stimulated by the realization that market mechanisms cannot always be counted on to achieve social goals. However, the benefits hoped for under particular regulations have not always been realized; and in some cases, the cost of enforcing regulations has turned out to be unrealistically high and has had unintended negative side effects.

Social regulations could be improved by infusing market incentives in enforcement practices. Increased attention needs to be given to evaluating the costs and benefits of the programs and introducing flexibility in achieving stated goals.

- When policy makers want to achieve stated social regulatory goals, they should devise incentives and penalties, rather than dictate one path that industry must follow in order to comply with the regulations.

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[6] See CED policy statement Strategy for U.S. Industrial Competitiveness.

Regulatory policy should be viewed as a dynamic process in which necessary regulations are implemented and enforced in a manner that does not generate unnecessary burdens on society as a whole or create unnecessary uncertainties about future implementation. Such an approach can both achieve the desired regulatory goals of the United States and enhance the international competitiveness of U.S. industry.

INTERNATIONAL TRADE POLICY

In the postwar years, the United States has played a leading role in establishing a world trade system based on the principles of a free and open market and in ensuring that national trade policies would not degenerate into beggar-thy-neighbor protectionism. This policy made an important contribution to economic growth and development here and abroad.

But today, U.S. trade policy stands at a critical juncture. Huge trade deficits and the rising debt to foreigners are fueling protectionist sentiment, which could reverse these gains. Protectionist measures are not the answer to the current U.S. trade problems. CED has consistently opposed the maintenance of trade barriers, whether domestic or foreign. CED's basic approach to trade policy, which is discussed in the recent policy statement, Toll of the Twin Deficits, involves enforcement of existing trade laws, reducing U.S. restrictions on its exports, encouraging exports, and promoting new GATT agreements.

Enforce Existing U.S. Trade Laws

U.S. trade laws provide a number of legislative means for dealing with trade problems. Some of these laws are explicitly directed at unfair practices by foreign producers; others focus on import disruptions under special circumstances. Both types need to be enforced because the reduction of foreign unfair trade practices is essential to maintaining the necessary environment for a genuinely liberal trading system and to encouraging changes in business behavior in the direction of mutually beneficial practices.

- While pressing for stronger international rules on unfair trade practices, the U.S. government ought to continue taking action against unfair trade practices in order to relieve the suffering in the areas of the United States hardest hit by such unfair practices and to ward off rising protectionist pressures.

Congress has recently supported trade legislation, some parts of which are protectionist in character. We should reject protectionist legislation that runs counter to the maintenance of an open multilateral trade system.

- In revising domestic trade laws, the United States should be careful not to enact measures that would evoke foreign retaliation, suppress open and fair competition, or undermine multilateral trade agreements.

Reduce U.S. Government Restrictions on U.S. Exports

Some internal impediments to U.S. exports are caused by U.S. government policies and regulations. These domestic impediments take various forms, but their common characteristic is a tendency to make U.S. exporters less competitive by providing a greater advantage to foreign producers who are free from such restrictions. Most of the complaints from U.S. exporters about these domestic impediments center on U.S. export controls on high-technology goods and the Foreign Corrupt Practices Act (FCPA). In general, the U.S business community supports strong controls on high-technology exports to the Soviet bloc countries. However, we believe that in some cases these strictures can be counterproductive.

- Unilateral controls by the U.S. government and the overly strict application of controls on a broad range of products should be avoided because such controls threaten to undermine U.S. competitiveness as a producer of high-technology goods.

On the question of foreign corrupt practices, CED recognizes the importance of discouraging corruption in international business. But standards should be clear and consistent.

- The next Administration should introduce legislation to clarify ambiguities in the FCPA and should negotiate an international agreement on foreign corrupt practices that would help eliminate the competitive disadvantages imposed on U.S. companies.

Promote U.S. Exports

Although the importance of promoting exports to resolve U.S. trade problems is recognized, efforts to do so seem inadequate. Many small and medium-sized companies lack the necessary information, resources, and personnel to explore export opportunities vigorously. It is reported that a small proportion of large U.S. corporations is responsible for about 80 percent of U.S. exports. CED has encouraged private businesses to pursue aggressive marketing efforts and undertake other changes to improve their competitiveness.

Support for GATT Uruguay Round

For the longer run, a more desirable approach in trade policy would be to strengthen GATT and to negotiate a stronger multilateral agreement to reduce nontariff barriers and eliminate unfair trade practices. The Uruguay Round negotiations will be extended to cover unresolved trade barriers in such areas as agriculture, services, intellectual property rights, and high technology. It is vital that the United States play a leading role in the successful conclusion of the Uruguay Round.

- The relevance of GATT for the world trading system is now at a crossroads. The new round of GATT negotiations needs to be supported and accelerated by the United States and other member countries.

One practical step would be for the United States to push for conclusion of early agreements (prior to the formal conclusion of the Uruguay Round) in selected areas that can be implemented quickly to produce some early beneficial results.[7] An early harvest in the GATT negotiations could be a constructive interim step toward successful conclusion of the Uruguay Round.*

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[7] See CED and Keizai Doyukai joint statement United States-Japan Trade Relations: A Critical Juncture, p. 27.

*See memorandum by W. Bruce Thomas, page 38.

Chapter 4

ENCOURAGING PRODUCTIVITY AND ECONOMIC GROWTH: HUMAN RESOURCES

U.S. economic growth and competitiveness are also strongly influenced by investment in human capital. In education, labor policy, health care, retirement, and other social welfare areas, the public sector can play a key role in implementing policies that improve the nation's long-run economic health.

EDUCATION

Investment in human capital is among the most important contributions government can make to assure continued growth in this nation's standard of living and its leadership role in a global economy. In two recent policy statements, Investing in Our Children: Business and the Public Schools and Children in Need: Investment Strategies for the Educationally Disadvantaged, CED called attention to a number of warning signals in the public education system which indicate that current investment is not generating the needed returns, either to individuals or to society. (See "Deficiency in the Employability of America's Young People," below.) We identified some specific actions that need to be taken if the nation is to improve the outcome of its nearly $200 billion expenditure on public elementary and secondary schools.

DEFICIENCY IN THE EMPLOYABILITY OF AMERICA'S YOUNG PEOPLE

Employers in both large and small businesses are concerned about the lack of preparation for work among the nation's high school graduates. Too many students lack reading, writing, and mathematical skills, positive attitudes toward work, and knowledge of appropriate behavior on the job. In addition, they have not learned how to learn, solve problems, make decisions, or set priorities. Many high school graduates are virtually unemployable, even at today's minimum wage.

Well over one-quarter of the nation's youths never finish high school. Another quarter graduate without even the minimal skill requirements, and even those who go on to higher education need remedial reading and writing courses, which about two-thirds of U.S. colleges now provide.

Nearly 13 percent of all seventeen-year-olds still enrolled in school are functionally illiterate, and 44 percent are marginally literate. Among students who drop out, an estimated 60 percent are functionally illiterate.

Investing in Our Children mapped out a strategy for improving the employability of public school graduates through broad-scale reform of the education system. Specifically, the report recommended changes where learning actually takes place: in the individual school, the classroom, and the interaction between teacher and students. This "bottom-up" strategy views the individual school as the place for meaningful improvements in both quality and productivity.

To improve the employability of public school graduates, students must be taught the basic skills needed in a modern technological society. A key skill is the ability to work effectively in the English language, which employers cite as one of the three most important employability traits. Equally critical for instilling the positive attitudes and work habits that will lead to later employability is the so-called invisible curriculum: the messages schools send to students about the levels of behavior and achievement that are prized by the adult world. If schools tolerate excessive absenteeism, tardiness, or misbehavior, students cannot be expected to meet standards of performance or behavior either in school or as adults. Other components of this "bottom-up" strategy include improving the quality of the teacher work force, substantially reforming the vocational education system, improving education and research data collection, and promoting business-education partnerships.

Investing in Our Children found that preventing failure in the early years of schooling is significantly more effective, both for individuals and for the nation as a whole, than remedial measures in later grades. More resources, therefore, should be devoted to the early stages of educational development, particularly preschool programs for disadvantaged children, the elementary grades, and middle schools. Quality preschool programs are particularly cost-effective. The most recent evidence indicates that for every $1 invested in a quality program, such as the Perry Preschool model in Ypsilanti, Michigan, society will reap a substantial $6 savings.

Education for the Disadvantaged

CED's research in education has spotlighted the overriding importance to the nation's economic and social vitality of focusing reform efforts on reducing the large number of children from disadvantaged families who are not well provided for by the education system. CED's most recent education study, Children in Need, calls for early and sustained intervention in the lives of disadvantaged children to give them a better start in life and enable them to meet the challenges of education and work.

Immediate action is necessary to halt the continued growth of a large, permanent underclass of young people who cannot qualify for employment because they lack fundamental literacy skills and work habits. Many cannot attain an adequate living standard because they are trapped in a web of dependency and failure. Yet our schools, traditionally the pathway out of poverty, are failing to provide disadvantaged children with the skills and knowledge they need to be successful in mainstream society.

Reforms of the past five years have been targeted largely at the education system as it is now structured and have achieved only limited success. Strategies aimed at the system alone will continue to fail a substantial portion of America's children who lack the basic early preparation that would allow them to take advantage of educational opportunities. Instead, what is needed is a national commitment to helping disadvantaged children from their earliest years. Effective strategies must address the broader needs of these children, especially from prenatal care to age five, because such action is most likely to prevent later failure. Business, education, parent organizations, civic groups, and all levels of government need to work together to generate the political will to accomplish the task of preparing all our children for the future. Business in particular should take the lead in advocating a greater investment in the education of disadvantaged children because these children have no voice of their own.

Conservative estimates suggest that as many as 30 percent of all children are educationally disadvantaged because of poverty, racial discrimination, or neglect. Many of these children grow up in a deprived environment that slows their intellectual and social growth. The high rate of failure among the disadvantaged underscores the need for solutions that reach beyond the traditional boundaries of schooling to improve the environment of the child. We recommend a three-pronged approach to achieve the goal of reducing failure among disadvantaged children: (1) prevention through early intervention, (2) a fundamental restructuring of schools that serve the disadvantaged, and (3) retention programs for students at risk of dropping out and reentry programs for those who have already left the system.

- Early intervention calls for programs that focus on children from prenatal care through age five and on the teenagers who are at risk of premature parenthood. Programs designed to achieve the following goals would be especially beneficial: encourage pregnant teenagers to stay in school and dissuade young adolescents from becoming parents in the first place; provide prenatal and postnatal care for pregnant teens and their babies; provide parenting education for all at-risk parents; and provide quality child care and preschool programs.

- School restructuring requires fundamental changes in the ways schools are organized, staffed, managed, and financed. This would include smaller schools and smaller classes; school-based management with shared decision making and accountability; specialized teacher training and recruitment; support services within the schools that provide health care, counseling, and related services; increased emphasis on extracurricular activities that reinforce academic, social, and physical skills; and greater parental involvement.

- Retention and reentry calls for special programs to encourage at-risk high school students to stay in or return to school. These programs should include meaningful work experience that reinforces basic academic learning, alternative schools within the larger school structure, improved guidance counseling, and continuity of program design and funding.

To accomplish these goals, broader and more innovative partnerships are needed between business, educators, government and the community at the local, state, and federal levels.

Historically, the federal government has had an important role to play in targeting resources to children in need. It needs to reaffirm this long-standing commitment to ensuring the disadvantaged access to quality education. This affirmation should include both establishing and funding demonstration projects in early childhood education and dropout prevention and other programs targeted to children in need.

- The remedial reading and mathematics programs of Chapter 1 (Education Consolidation and Improvement Act of 1981) and Head Start have had demonstrable success, and federal funding of both programs should be brought up to levels sufficient to reach all eligible children.

- Federal funding of high-quality research, development, evaluation, and technical assistance is more important than ever for Chapter 1, Head Start, and related programs.

The costs of providing a quality education to all the nation's children will be high. But if the nation fails to act, the true cost to society and individuals will be far higher. More fully developing the talents of our children in need and simultaneously improving their lives are among the best investments this nation can make in its future.

Higher Education

Collegiate education is an area of relative strength in the United States. However, one special concern from the viewpoint of longer-term performance of the economy is the need to ensure an adequate supply of highly skilled workers such as scientists and engineers. The U.S. higher education system, particularly at the graduate level, is not training enough American engineers and scientists to support today's rapidly changing technology. The federal government needs to take action to remedy this situation. Where necessary, it should provide sufficient incentives to rectify shortages in scientists and engineers.

LABOR POLICY

Intense international competition has heightened the need to improve the capacity of labor markets to adapt to changing economic conditions. A relatively flexible labor market has long been an inherent strength of the United States and a source of significant competitive advantage over its chief foreign competitors. It is important to preserve and enhance that advantage at this critical juncture, wherever that can be done to the long-run benefit of both employers and employees.

In Work and Change: Labor Market Adjustment Policies in a Competitive World, CED presented a whole range of tested actions that government managers and workers can take to improve the flexibility of the U.S. work force. The following actions were among the most important actions suggested in that statement.

- Incentives for reemployment, especially through a restructuring of the unemployment insurance system

- Coordination of public-sector and private-sector resources at the state and local levels to facilitate quick and effective responses to plant closings

- Educational reform to offer the skills needed to prepare students for a changing marketplace

- Job-training programs involving local industries

Concurrently, because we recognize that management and labor are ultimately responsible for the competitiveness of U.S. business, we urge private-sector leaders to adopt the following measures:

- Improved communication between management and labor regarding the business's competitive position

- The use of flexible total compensation as a means of keeping wage and benefit costs more in line with the business's competitive position

- Voluntary, advance notification of decisions affecting jobs, particularly in the cases of plant closings, work transfers, and automation

- Support programs to help employees move to new opportunities both within the firm and outside

CED strongly believes that business should voluntarily provide as much notice as possible to employees about decisions that affect an individual's job status, such as plant closings, work transfers, or automation. However, CED is concerned about attempts to specifically legislate such notice, and opposes, in particular, language requiring advance notice regarding layoffs. These kinds of specific mandates fail to take into account either the highly diverse nature of U.S. businesses or the wide array of business circumstances that cause these actions to be taken. Such inflexible mandated notice would be especially damaging to smaller businesses, and would introduce a new rigidity at a time when the pressures of globalization and intense international competitiveness require even greater flexibility in labor markets.

HEALTH CARE

Well-targeted expenditures on health care are vital investments in human capital and thereby help improve labor productivity and economic growth. They also reflect society's desire to minimize the pain and suffering associated with illness. The extent to which these objectives are met, however, depends on how wisely those expenditures are made; and in recent years, Americans have not always spent wisely. (See "Rising Costs and Limited Access in Health Care," page 25.)

In many cases, the best way to achieve the goal of more moderate growth of health care costs while maintaining high standards of care and increasing access to services is through increased reliance on market incentives. Businesses could offer a

RISING COSTS AND LIMITED ACCESS IN HEALTH CARE

Since the mid-1970s, the U.S. health care system has been confronted with the problem of rapidly escalating costs, which have been an important factor in increasing labor costs and decreasing U.S. competitiveness.[a] In 1965, health care was a $42 billion-a-year industry; but by 1985, it had grown to a $425 billion industry. In that year, 10.7 percent of the nation's GNP was devoted to health care, the highest proportion in the world.[b] Part of the increase in the ratio reflects improvements in quality; and part, above average inflation for the health care industry. However, the increase also reflects the high cost of an inefficient financing system. It is important that these costs be held in check so that it does not absorb resources that could be used for greater benefit in other vital activities that improve the nation's economic health.

Despite the phenomenal growth of public- and private-sector expenditures on health care insurance, a substantial portion of the population continues to have inadequate access to health services. An estimated 35 to 37 million Americans lack the insurance coverage that facilitates access to the benefits of the health care industry.

Both government and the business sector have made useful changes in the way they purchase health care. But unless further reforms are effected, health care costs will continue to rise sharply, further limiting the availability and quality of health care as well as diverting resources from other important social and economic needs.

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[a] Reforming Health Care: A Market Prescription, p. 2.

[b] Reforming Health Care: A Market Prescription, p. 1.

wider choice of health plans to workers and create incentives for them to select a cost-effective plan, reduce health care costs by improving workplace safety, stimulate employee participation in wellness programs, and help increase coverage by experimenting with programs designed to help the elderly insure themselves against any long-term care.

The public sector also has an important role to play both in encouraging private-sector actions and in correcting market outcomes deemed socially unacceptable. Government action should be concentrated in three basic areas: (1) helping to contain escalating health care costs by removing current disincentives for effective private-sector health care policies; (2) assisting the poor and elderly who are unable to purchase adequate health care coverage on their own; and (3) ensuring that the United States maintains a high quality of health care.

The government has a major role to play in encouraging cost-effective private-sector involvement in health care. Government should remove barriers to entry in the health care industry, just as it would in any other sector of the economy. It should also spurn rate controls. The rate and entry controls approach of a standard regulatory model will stifle innovation and entrench inefficiency. When appropriate, the government should endorse the use of market principles in both public- and private-sector health care programs.

- Government policies should avoid regulating the entry of new private health care providers and the supply of health care facilities.

- Government should also avoid regulating the services to be provided in benefit plans and the price of these services.

The objective of limiting government intervention and increasing reliance on market incentives is to enable the private sector to provide health care more efficiently and economically.

Nevertheless, some government action in the area of health care is necessary. Although the growth of private-sector health insurance has increased access to quality care, private markets cannot guarantee access for most of the elderly, uninsured workers, and those with insufficient resources to pay for necessary health care. The government needs to fill these gaps in health care insurance and, through Medicaid and Medicare, has done so for a substantial number of the poor and elderly. However, millions of Americans still do not have adequate coverage, and indirect subsidies that formerly financed a considerable amount of indigent care are rapidly being eroded. As the individuals who pay the employee health care bill seek lower-cost providers, they are unwilling to cover the cost of uncompensated care for indigents by paying more than the market rate for services. New, direct, and more efficient ways of subsidizing indigent care will have to be found. Furthermore, policy makers face an additional challenge in attempting to provide these subsidies by relying on market incentives rather than on rigid government controls in order to achieve the best-possible value for health care outlays.

- Government subsidies for indigent health care should be based on actual financial need, not, as they currently are, on measures of categorical groups and personal characteristics, and should be provided directly to the beneficiaries, thereby eliminating government underwriting of inefficient providers.

- The federal government should also gradually move toward a voucher system of payments for health care providers to allow those receiving subsidies to make cost-effective decisions, where feasible, about their treatment.

The adoption of these market-oriented principles will require a reform of Medicare and a broadening of the financing base for indigent care. A greater measure of protection for long-term care and catastrophic illness should also be considered in reforming Medicare.

Finally, the government has a role to play in seeing that a high quality of health care is maintained in the United States. In the past, much basic clinical R&D has been indirectly subsidized by those who paid above-market prices for routine care in teaching hospitals. Market incentives and more cost-conscious purchasing of health benefits by employees and employers may limit this source of funds. It is important, therefore, that the government support basic medical research and accelerate the marketing of new medical devices judged to be safe and effective.

- Additional funding for basic research should be made available through a system of government grants administered through the National Institutes of Health.
- The costly drug-approval process should be accelerated by allowing greater participation of scientific experts from outside government, as well as representatives of patients who may benefit from the drug, in the approval process. The current acquired immune deficiency syndrome (AIDS) epidemic gives urgency to the need for a more effective drug-approval process.

Moreover, the availability of new medical devices should be widened to allow more people access to the newest technologies:

- The review of whether a new device will be reimbursed under Medicare should be initiated prior to the completion of the Food and Drug Administration (FDA) approval process. This would avoid unnecessary delays in making these devices available to Medicare patients.

RETIREMENT POLICY

Public and private pension systems in the United States affect both the availability of domestic sources of capital and the quality of the labor force--two factors that greatly influence our international competitiveness and long-run economic growth.

Pension systems have a substantial impact on the quantity and quality of the labor force by affecting early retirement decisions. Demographic projections indicate that because of aging and retirement, there will be a shortage of skilled workers by the early part of the next century. At that time, almost one-fifth of the American population will be over the age of sixty-five. The combination of this increased elderly population and the steady drop in the U.S. birthrate since 1960 will create a dramatic rise in the proportion of nonworkers to workers if current trends continue.

The aging of the population could adversely affect future economic growth not only because of the labor shortages it will create but also because it will place a very heavy strain on the availability of domestic sources of capital. Economic growth will diminish if resources are diverted from investment to pay retirees' needs. This situation argues for policies that encourage workers to delay retirement.

It now appears that the reforms enacted in 1983 will result in large surpluses in the Social Security trust fund during the next twenty years. In fact, the latest CBO report forecasts a surplus of $37 billion in the current fiscal year and a total surplus of almost half a trillion dollars by 1993.[8] Nevertheless, the Social Security system's long-term solvency is less certain, and its current surpluses may not be sufficient to avoid real hardships and insecurity for future retirees and inequitable burdens on future working generations. Thus, our retirement system needs to be reevaluated to ensure sound practices. Given the huge current rise in the federal funds deficit (i.e., excluding Social Security funds) and the rise in our debt to foreigners, there will be substantial burdens on future generations in addition to retirement funding. Consequently, the government should strongly consider policies to increase national saving.

Those who have already retired or who are retiring now receive much more from the Social Security system than they paid into it. However, it is very likely that contributions will increase relative to benefits in future years. We believe that public and private retirement policies need to be forged to achieve two goals: (1) a minimum level of retirement income for all workers and their families and (2) an environment in which both workers and employers have the opportunity and the responsibility to meet their own retirement income goals above their minimum level of income.[9] To accomplish these goals, a three-tiered strategy should be emphasized, with Social Security providing the first tier of support, employer pension plans the second, and personal savings the third. Increased reliance on private saving is an important stimulus to private investment and long-run economic growth, and it may also reduce pressures for increased benefits from the public sector.

In Reforming Retirement Policies, CED urged broad reforms in both public and private pensions. Some, though not all, of the proposed policy changes in the Social Security system have become law. However, additional reforms are needed to improve the equity and financing of the Social Security system.

- The normal retirement age for Social Security should be raised to sixty-eight and the early retirement age to sixty-five for those who can work that long. This should be phased in gradually so that no abrupt change occurs for anyone about to retire, but it should go into effect much more promptly than is contemplated under current law.[10]

- In years when the average wage of workers rises less than the annual increase in the Consumer Price Index, the annual automatic increase in Social Security benefits should be at the same rate as the rise in average wages. Under the current law, average wages are employed for indexing only when the combined assets of the Social Security retirement and disability trust funds fall below a specified percentage of annual outlays.

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[8] Congressional Budget Office, The Economic and Budget Outlook (Washington, D.C.: U.S. Government Printing Office, February 1988), p. 77.

[9] See CED policy statement Reforming Retirement Policies, p. 5.

[10] The present law provides for a gradual raise in the regular retirement age beginning in the year 2000, eventually reaching sixty-seven in the year 2027.

- Fifty percent of all Social Security benefits should be taxed. Currently, 50 percent of benefits are taxed only when the taxpayer's combined income exceeds a $25,000 threshold for a single return and $32,000 for a joint return.

Now that the tax law has been reformed, the elderly poor are exempt from income taxation by more generous personal exemptions, the regular standard deductions, and special deductions for the elderly. CBO has estimated that if the thresholds were eliminated, these provisions in the income tax code would still exclude 46 percent of recipient households from having to pay any tax on Social Security benefits.[11]

Employer pension plans should provide the second tier of retirement income. To accomplish this, policies need to be developed to increase the coverage and flexibility of these plans. The private sector must take the lead in expanding these plans and designing them to take the capabilities and interests of older workers into account, but public-sector policies can strengthen this tier as well:

- Changes in the tax laws and regulatory policy should make it more attractive for employers to establish pension plans.

In addition, the government might consider requiring employers who do not have an employer-based pension plan to establish a 401K plan and provide payroll deductions if a majority of the employees voted for establishing such a plan.

To ensure that older workers and retirees can lead full and meaningful lives:

- Any existing regulations and labor market policies that inhibit flexibility in work arrangements for older workers should be removed.

The third source of retirement income, personal savings, has been greatly neglected and we urge that more attention be focused on both private and public actions that encourage private saving.

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[11] Congressional Budget Office, Reducing the Deficit: Spending and Revenue Options (Washington, D.C.: U.S. Government Printing Office, March 1988), p. 326.

Chapter 5

IMPROVING THE PERFORMANCE OF THE PUBLIC SECTOR

For many years, CED has had an interest in improving the management of federal, state, and local governments and has published several policy statements on this subject.[12] In this chapter, we briefly review those management issues of interest to the next President and to state and local officials. We also address economic policies at the state and local levels which have important implications for the vitality of the U.S. economy as a whole.

MANAGEMENT IN GOVERNMENT

The policies recommended for the federal government in Chapters 2, 3, and 4 will not achieve their objectives if they are not managed skillfully. At the heart of efforts to improve the government's efficiency and effectiveness are the capability and motivation of federal personnel. No President, even with the support of an extensive White House and Executive Office staff, can expect to manage the massive and complex federal establishment without winning the loyalty and fully utilizing the talents of the men and women in public service.[13] Although reforms in the civil service system have been adopted in recent years, greater efforts are needed to achieve a closer relationship between pay and performance and to evaluate those reforms already put in place.

As the federal government has cut back on grants to state and local governments, the initiative for many domestic policies has shifted to the state-local sector. This shift makes it all the more important that state and local governments achieve the highest-possible degree of professionalism in government policy and management. In anticipation of this shift, the CED policy statement, Improving Productivity in State and Local Government, calls for the adoption of new approaches to the delivery of public services. It stresses the importance of better management, strengthening the work force, the improved application of capital and technology, and more effective use of the private sector to provide public services. Although improvements have been made recently in many of these areas, there is a new appreciation of the need for improving the effectiveness and efficiency of increasingly burdened state and local governments. In Improving Management of the Public Work Force: The Challenge to State and Local Government, CED has called attention to the importance of human resources in the delivery of public services.

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[12] CED has also addressed problems in the legislative process and made numerous proposals for reforming the federal budget process. (See "The Federal Budget Process," pages 8 and 9 in this statement.)

[13] See CED Program Statement Revitalizing the Federal Personnel System.

It is apparent, however, that state and local governments cannot handle the increased load alone. They need the involvement of the private sector. In CED's policy statement Public-Private Partnership: An Opportunity for Urban Communities we have outlined an agenda that would enable government, business, neighborhoods, and nonprofit organizations to work together to address problems of mutual interest. Considerable progress has been made already in developing a wide range of public-private partnerships at the state and local levels throughout the United States.

In fact, it is at the state and local levels that some of the most imaginative public policies and private-sector initiatives have occurred in the past decade. The challenge today is to build on that experience and redouble those efforts in bracing for the even greater challenge that confronts state and local governments in the future.

Many of the policies recommended in this report will require action by state governments. These include:

- Investing in primary and secondary education
- Preventing and remedying the problems of the educationally disadvantaged
- Stressing reemployment in the Unemployment Insurance program
- Assisting dislocated workers in adjusting to new jobs
- Strengthening technology and the links between university and business
- Promoting exports on the part of small and medium-sized businesses

This wide range of state involvement in key public policy issues is a reflection of the substantial powers that reside at the state level. Over the past decade, states have begun to exercise these powers in innovative ways. In a sense, they have become the policy leaders on key issues facing the country. In no area is this more the case than in economic policy.

ECONOMIC POLICIES OF STATE AND LOCAL GOVERNMENTS

CED studies have highlighted the critical role that state and local governments play in the health of the economy. Local governments provide basic services--such as education, infrastructure, and natural resource management--that are important to the economic health of the private sector. State governments are the link in economic federalism, often implementing and managing federal policies. State governments also satisfy a need for experimentation with different government policy approaches. When the experiments work, other states and the federal government can adopt their approaches. When the experiments fail, instructive experience has been gained without damaging the whole economy.

- The federal government should be careful that its policies do not stifle such creativity at the state and local levels.

In regard to economic development, successful states no longer focus exclusively or even principally on recruiting outside businesses to locate in the state. Instead, they focus most of their energies on providing the appropriate environment for fostering development from within the state. In Leadership for Dynamic State Economies, we describe a strategy for state governments to encourage economic growth from within.

- The key to economic vitality is a dynamic, market-driven private sector. State governments need to assure that their policies facilitate change and support innovation in the private sector.
- States need a broadly conceived strategy to identify priority actions, to give cohesion to government actions, and to avoid actions that may be harmful to the economy.
- Economic strategy for the states has these components: (1) diagnosis of the state's economic potential and evaluation of current policies in the light of changing economic conditions; (2) vision to see the policies needed to create a climate conducive to entrepreneurship; and (3) actions that are specific, timely, and accountable.

The key ingredients needed to implement institutional action are: (1) leadership from all sectors (including government, business, labor, universities) to direct individual institutions toward productive economic actions and (2) partnerships among institutions in the public and private sectors to link common interests and mobilize resources to the benefit of the state economy as a whole.

In Public-Private Partnership: An Opportunity for Urban Communities, CED points out that public-private cooperation has great potential for development in urban communities. Local governments should initiate and encourage public-private joint ventures and private activity for the public benefit. Individual and corporate involvement and leadership can be sources of energy and vitality in urban America.

Chapter 6

DOMESTIC ECONOMIC POLICIES AND U.S. LEADERSHIP

The goal of the policies recommended in this statement is to improve economic growth, stability, and competitiveness in the United States. A healthy, growing economy is necessary both to improve economic conditions for our citizens and to enable the United States to maintain its leadership position in the world.

Without sufficient growth, we will not have the resources to improve the quality of life for our children. Although Americans take great pride in the fact that their standard of living is one of the world's highest, in some ways their quality of life still does not measure up. Our average life expectancy is lower than that in twelve other countries; our rate of infant mortality is worse than in thirteen other countries; our standards of education and literacy lag behind those of a number of other advanced countries; and major crimes are more prevalent here than in many other countries.[14] Recent data indicate that except in the case of the elderly, we have made no progress in reducing the proportion of people living below the poverty level during the last decade. Indeed, about one child in five American children today is born into poverty.

It is widely understood that a healthy economy is a precondition for improving social conditions at home, but it has only recently been recognized that a dynamic domestic economy also plays a role in U.S. leadership abroad.

THE U.S. LEADERSHIP ROLE IN THE WORLD

For most of this century, the United States has been the leader of the free world. It has worked continuously for economic progress at home and abroad, often going out of its way to help other countries as part of a broad conception of its self-interest. After World War II, this country strongly promoted economic recovery of the nations devastated by war. Since that time, it has frequently used its influence to encourage political freedom, military security, and the economic development of both the advanced and the developing countries.

U.S. international leadership is as necessary today as it was in the past. It is needed to encourage the nations of the world to take advantage of the new opportunities for prosperity that are presented by new technology and efficient economic organization. It is also needed to counter the many dangerous forces that appear to be on the rise in the world and would undermine progress already achieved. These forces include mercantilistic tendencies that threaten free trade; international drug traffic and crime that threaten our security and well-being; political repression and armed insurgencies that threaten freedom in many places; and violent terrorism that generates fear and undermines constructive resolution of problems. Leadership from the United States is needed to organize effective opposition to these dangerous trends.

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[14] World Resources Institute and The International Institute for Environment and Development, World Resources 1986: An Assessment of the Resource Base that Supports the Global Economy (New York: Basic Books, Inc., 1986), pp. 238-239, 242-243.

However, the U.S. role as an international leader requires a different approach in today's world. The other major industrial nations have grown to positions of economic strength and influence that should be taken into account. Rapidly developing nations now have a significant impact in many markets. And the rising populations elsewhere in the world, now dwarfing our own, are pressing for more consideration. The significance of all these changes is magnified by the much greater international economic interdependence being created by the progressive globalization of markets for financial assets, goods, services, and technology.

This kind of world calls for a higher ratio of consensus building to unilateral action, of mutual cooperation in contrast with go-it-alone or do-it-my-way policies, at least among friendly nations. Even when it is impossible or very time-consuming to reach a consensus, the impact of interim unilateral national action on friendly nations must be taken into account, and the feedback from such action must be considered.

To be an effective world leader in this changed environment, a nation must: (1) provide an example at home; (2) have a realistic vision for its own development and of the world; (3) have resources sufficient to generate forward momentum; and (4) have the desire and ability to act in pursuit of its vision. Clearly, the United States still has the potential resources needed for such leadership. But in some respects, we have not managed our resources well. Our budget and trade deficits, as well as certain pressing social problems, suggest that we have not kept our own house in order. It is difficult to be a poor performer at home and the world's largest debtor and at the same time lead others to appropriate economic and political behavior. But our international leadership position can be buttressed if our political leaders demonstrate the ability and will to act in timely fashion to deal with our major domestic problems.

BUILDING A CONSENSUS FOR ACTION

For several years, the U.S. political system has been very slow to act on several issues that are basic to the welfare of our society. This seeming inability to come quickly to grips with important domestic policy problems such as the federal deficit and the festering social problems of poverty, drugs, and crime is damaging our economy, our quality of life, and our ability to lead other nations toward a better life. Such key inadequacies are detracting from the successes we have achieved in other respects. It is time for the United States to demonstrate--to itself and to the world--a more effective ability to deal with these problems.

In part, the paralysis of the political system on these issues reflects its great sensitivity to the wishes of many diverse groups in our society. However, some special-interest groups have narrow objectives and successfully block progress in other areas. Others have deeply held ideological views that magnify differences far beyond their practical importance. What is needed in this environment is strong political leadership to develop a consensus for action. Timely political compromise to achieve a working consensus dealing with key domestic issues is needed before the problems become much worse and much more costly to cure. Only in this way can the United States resolve its problems and retain its critical role as the leader of the free world.

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MEMORANDA OF COMMENT, RESERVATION, OR DISSENT

Page 10, by **W. Bruce Thomas**

The United States currently imports over 60 percent of total LDC exports of manufactured goods. Japan and the EC must be encouraged to take a larger share of these exports.

Page 12, by **Philip L. Smith**

I continue to believe that the federal deficit should require further reductions in federal spending. However, should the time come when federal spending is clearly declining as a per cent of GNP and additional revenues must be raised to close the gap further, a temporary, declining income tax surcharge would seem appropriate. Such a surcharge, superimposed on the more level playing field established by the 1986 Tax Reform Law, appears to represent the fairest, least disruptive approach for our economy and one that should achieve a balanced budget within a reasonable amount of time.

Page 13, by **James Q. Riordan**, with which **Roderick M. Hills** and **W. Bruce Thomas** have asked to be associated

The report correctly emphasizes (1) that we need to eliminate disincentives to savings and investment and (2) that any new tax proposals should be judged not only in terms of their hoped-for impact on the deficit but also on their effectiveness in promoting savings, investment and growth.

Unfortunately, the U.S. income tax law (a) imposes a double tax on corporate earnings, (whereas many other industrialized nations have systems for ameliorating such double taxation); (b) burdens foreign investment by U.S. companies more heavily than the systems of other industrialized nations and (c) permits slower capital recovery than do our competitors.

The 1986 Tax Reform Act paid for the welcomed lowering of income tax rates by increasing the tax on corporations and increasing the disincentives for investment here and abroad. If we were to again increase corporate income taxes in an attempt to reduce the deficit we would further discourage savings, investment and growth. New taxes if needed should be imposed on consumption.

Page 14, by **Donald E. Guinn**, with which **Philip A. Campbell** has asked to be associated

The national set of telecommunications networks forms as vital a part of the productive infrastructure as transportation and water systems, and should be acknowledged as such when developing economic policy. In fact, our economic dependence on telecommunications is increasing rapidly; our society becomes more information-oriented by the day, propelled by rapid change in the ability of computers to communicate with each other over telephone networks. While recent changes in telecommunications industry structure have stimulated growth and innovation in some types of network services, the complex web of current state and federal policies – legislative, regulatory and judicial -- do not provide coherent incentives for broad scale network investment or technology development. Meanwhile, several of our largest international competitors have targeted the telecommunications sector as critical to their national economic development and have already instituted policies which highlight its importance. All U.S. efforts to conserve and promote our economic infrastructure must therefore include a more coherent set of policies designed to foster investment in the capabilities of our telecommunications networks, for the future benefit and security of all elements in our society.

Page 15, by **John Diebold**, with which **William F. May** has asked to be associated

In any consideration of technology and public policy, I believe that attention should be given to the potential role of privatization in the delivery of public services. By creating a domestic market for societal infrastructure systems, private investment will be forthcoming for the development of technology based services. This is precisely the kind of commercial market technology with high export potential which we need to encourage and which we have consistently shown little interest in funding publicly. These services are today almost entirely labor rather than capital or technology intensive. Efforts to push the use of technology in these areas have consistently been about as effective as pushing a string. It is my belief that if a demand pull could be created via the profit incentive, substantial additional private investment would be applied to R&D as well as facilities in the many large societal infrastructure projects that will inevitably represent a large part of the worldwide application of technology in the years ahead.

Technology suitable for such uses as: road as well as air traffic control; community security and fire detection; and education and medical service delivery, will represent an increasing portion of world technology markets. By focusing on the creation of domestic markets in these areas, through privatization, rather than relying on government expenditures, there is a considerable opportunity for the development of proprietary U.S. technology with sizable markets abroad.

This is only one of several areas in which attention to the changes in institutional relationships and processes in the public/private interface deserves attention as a means of materially benefitting U.S. international competitiveness.

Page 19, by **W. Bruce Thomas**

If the recommended trade-related actions all take place and the U.S. merchandise trade and current account deficit continue at unreasonable levels, the approach suggested by former Secretaries Vance and Kissinger in their recently published, "An Agenda for 1989," should be considered. They recommend that in the case of Japan, "The American-Japanese dialogue must not be confined to mutual harassment. The two countries should seek to establish overall goals and work toward them. One step would be to establish an overall trade balance the United States would find tolerable; within that balance, Japan would have the choice of either reducing its exports or increasing its imports, thus removing the need for sector-by-sector industrial negotiations."

OBJECTIVES OF THE COMMITTEE FOR ECONOMIC DEVELOPMENT

For over forty years, the Committee for Economic Development has been a respected influence on the formation of business and public policy. CED is devoted to these two objectives:

> To develop, through objective research and informed discussion, findings and recommendations for private and public policy that will contribute to preserving and strengthening our free society, achieving steady economic growth at high employment and reasonably stable prices, increasing productivity and living standards, providing greater and more equal opportunity for every citizen, and improving the quality of life for all.
>
> To bring about increasing understanding by present and future leaders in business, government, and education, and among concerned citizens, of the importance of these objectives and the ways in which they can be achieved.

CED's work is supported strictly by private voluntary contributions from business and industry, foundations, and individuals. It is independent, nonprofit, nonpartisan, and nonpolitical.

The 225 trustees, who generally are presidents or board chairmen of corporations and presidents of universities, are chosen for their individual capacities rather than as representatives of any particular interests. By working with scholars, they unite business judgment and experience with scholarship in analyzing the issues and developing recommendations to resolve the economic problems that constantly arise in a dynamic and democratic society.

Through this business-academic partnership, CED endeavors to develop policy statements and other research materials that commend themselves as guides to public and business policy; that can be used as texts in college economics and political science courses and in management training courses; that will be considered and discussed by newspaper and magazine editors, columnists, and commentators; and that are distributed abroad to promote better understanding of the American economic system.

CED believes that by enabling business leaders to demonstrate constructively their concern for the general welfare, it is helping business to earn and maintain the national and community respect essential to the successful functioning of the free enterprise capitalist system.

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IDEP	Institut de l'Entreprise 6, rue Clément Marot, 75008 Paris, France
経済同友会	Keizai Doyukai (Japan Association of Corporate Executives) Japan Industry Club Bldg. 1-4-6 Marunouchi, Chiyoda-ku, Tokyo 100, Japan
PSI	Policy Studies Institute 100 Park Village East, London NW1 3SR, England
SNS	Studieförbundet Näringsliv och Samhälle (Center for Business and Policy Studies) Sköldungagatan 2, S 11427 Stockholm, Sweden

Chairman ROSTENKOWSKI. Thank you, Mr. Woodside.

Any questions for the witness?

Mr. Woodside, I know that you are in a hurry, and I'm——

Mr. WOODSIDE. Mr. Chairman, I am not in that much of a hurry.

Chairman ROSTENKOWSKI. Well, I appreciate, you know, your observations and I do think that one of these days we are going to assume the responsibilities that we were elected to assume and start leading. Although it could be a problem for some of us, but I think that the time has come, as you witnessed the American people recognized, that we have problems, and that we have got to do something about them.

I am just convinced after having served here, this is my 31st year, that sometimes the people get way ahead of us as members.

If we are willing enough as representatives to go back and explain the reasons and the ramifications of the actions that we take—I remember going home in the Social Security dilemma that we found ourselves. And the minute some 5 or 6 o'clock news broadcaster frightened the daylights out of Social Security recipients in the day rooms of the senior citizens quarters, the telephone in our office would jump off the hook.

I went over there and sat in their day room and explained to them exactly what we were trying to do, and it was amazing how those people said "Well, Danny, you're a pretty good kid—"I am a kid—"and we knew that you wouldn't do anything that would hurt us." They are willing to make the sacrifice, but they frighten so easy. We have just got to assume our responsibility to be able to explain what we are trying to do as a government, because really they are the pioneers. We are just kind of the afterthoughts.

Mr. WOODSIDE. Well, Mr. Chairman, we certainly recognize the enormous difficulties that we have talked about, or I have talked about so glibly here, but it seems to me that in the long run, unless we get onto investing in this Nation's future, in terms of its people, its education processes and the rest, we are going to be preserving a country that is not going to be really worth very much 20 years down the road. And that is our basic concern.

Mr. ANDREWS. Thank you, Mr. Chairman.

During my campaign, when I first ran for Congress, I studied the Social Security system, and in a radio interview with my opponent I enumerated the things that I thought should be done back in 1981. I suggested raising the age to 68, taxing some Social Security benefits, and my opponent made a radio commercial out of my voice attacking me for taxing Social Security recipients and raising the age to 68.

My mother was 63 years old during that campaign. I am not sure she voted for me in 1980.

You are going beyond being glib this afternoon, but I do think your suggestions have much merit, and I think if nothing else they point out the really difficult time we are going to have on decisions relative to spending and revenues, and we really are down to the rug on some of these domestic programs, and it is going to be very difficult to find that balance.

I doubt we can reopen that Social Security box again. That was a painful debate in 1983, as I am sure you remember.

Mr. WOODSIDE. I do indeed.

Chairman ROSTENKOWSKI. Mr. Shaw.

Mr. SHAW. Thank you, Mr. Chairman.

I would like to also congratulate you for a very concise and thorough testimony. It is sort of interesting to see your comments and the comments that the chairman has made to you and to the previous speaker.

I think that part of the problem, of course, is us because of the political nature of so many of these things. Coming from an area, Fort Lauderdale, Florida, where we have got a very senior population, I can assure you that I am very sensitive, perhaps even more so than Mr. Andrews to the dilemma that we find ourselves in anytime we start talking about Social Security.

We have got an aged population that becomes very skittish anytime you start talking about Social Security because it is their lifeline, it is their very security, and I can assure you as a Republican I still feel the sting of some of the rhetoric during campaigns as did Democrats certainly feel the sting of any rhetoric as it applies to increase taxes.

So, I guess from that standpoint, we have all been baptized in fire.

You brought up a couple of questions and a couple of points that I think are extremely interesting.

One, you brought up the lack of Federal investment in worn-out infrastructure. And then you talked about not being as competitive because of our failure on the business side to reinvest in capital.

This has been something we have covered as a committee all week in talking about leveraged buyouts and some of the other things.

How would you suggest, using the code, that we could encourage, in the private sector more capital investment so that we can assure that into the nineties that we will be more competitive abroad?

Mr. WOODSIDE. Well, I cannot simply because CED has not come out with a position statement, I cannot really take a CED position.

It seems to me that, and I have to tell I am not a great proponent of reducing the capital gains tax as a route to that. I think there have to be found some kind of special incentives for investment.

I have to tell you that my basic concern is that leveraged buyouts are going to produce the same problem for individual businesses that we are talking about here today for the United States, because the United States has a deficit that needs to be constantly refinanced and interest paid on it. Leveraged buyouts have the same thing within their own debt structure.

And the first thing that goes are things that deal with the future, research and development, planning expenditures, and the rest of it. And so, as the United States is slowly winding down, I think the process with leveraged buyouts is going to speed that up dramatically.

So, I don't have an easy answer. I am very dubious about the efficacy of specific legislative proposals that have been made so far, but I think something has to be done about the leveraged buyout situation.

Mr. SHAW. Did you all look at this? Focus your attention now on public investment, the infrastructure.

Did you do any examinations of the accounting procedures of the Federal Government? Did you look in at capital budgeting at all?

Mr. WOODSIDE. No. We are not as a group in favor of separating the capital budget from the regular budget, though we are in favor of distinguishing them so that they are readily apparent.

This capital infrastructure is an enormous problem. I am chairman of the Regional Plan Association of New York, New Jersey, and Connecticut, the oldest urban planning organization in the world. We are constantly faced with infrastructure problems that are extremely difficult once they get out of hand to correct.

The NTA situation in New York City will probably take another 10 years before we get it back to where it was 20 years ago, let alone showing really substantial improvement in the system. I think that is what is happening across the United States, and I think the Federal Government, as I may have mentioned in my remarks, has to take the lead in determining what the national priorities are and how it should it divvied up between the private sector, the Federal Government, and State and local governments in trying to bring us back to some kind of reasonable maintenance of our capital stock.

Mr. SHAW. Did you do any research into the effect of taking some of these trust funds, such as the highway trust fund, and the airport trust fund, off the budget?

Mr. WOODSIDE. Let me ask one of our resident geniuses here, Mr. Beeman.

Mr. BEEMAN. I do not think that we have that issue in recent years. Historically, CED's have taken a position which favors the unified budget concept of the budget concept, which would keep, of course, as many types of spending as possible within the same context in order to reflect total Federal credit demand.

Mr. SHAW. I would close, Mr. Chairman, by simply inviting the witness to look into the effect that the Government accounting system has upon Government decisions.

The fact is that we really operate on a cash budget situation where investment is never recognized as investment, but simply as an expenditure. Such decisions as renting or leasing Federal occupied space instead of buying Federal occupied space because of the immediate budget effect are disregarded.

We should also look at the situation of just budgeting a year at a time rather than getting into multi-year budgeting.

I think that politically it is going to have even an increasingly more devastating effect on the judgement of administrations and of the Congress.

Mr. WOODSIDE. Thank you.

We certainly will look further into this.

Mr. ANDREWS [presiding]. Thank you, very much, Mr. Woodside for your testimony today.

And this concludes our testimony this afternoon. We'll reconvene at 10 in the morning.

[Whereupon, at 4 p.m., the hearing was adjourned, to reconvene at 10 a.m., Thursday, February 9, 1989.]

THE BUDGET DEFICIT, THE STATE OF THE U.S. ECONOMY, AND FEDERAL BUDGET POLICY FOR FISCAL YEAR 1990 AND BEYOND

THURSDAY, FEBRUARY 9, 1989

House of Representatives,
Committee on Ways and Means,
Washington, D.C.

The committee met, pursuant to call, at 10 a.m., in room 1100, Longworth House Office Building, Hon. Dan Rostenkowski (chairman of the committee) presiding.

Chairman Rostenkowski. This morning we begin our third day of hearings on the budget of the Nation's economy.

Our panel consists of present, acting or former Directors of the Congressional Budget Office. From their experience, they should certainly be able to provide us with the insight that will assist us in reducing the budget deficit.

Mr. Blum, Ms. Rivlin, and Mr. Penner, welcome to the committee.

It is always a pleasure to have you here with us. We look forward to hearing your testimony.

Mr. Blum, if you would begin.

STATEMENT OF JAMES L. BLUM, ACTING DIRECTOR, CONGRESSIONAL BUDGET OFFICE

Mr. Blum. Thank you, Mr. Chairman.

It is a pleasure to be here this morning with the committee to discuss the Federal budget outlook as well as the economic outlook and the need to reduce the Federal deficit. It is also a pleasure to join my former colleagues at the witness table here this morning.

In the last several weeks CBO published two reports relating to this subject which are, I think, before the members of the committee this morning.

First, the economic and budget outlook for fiscal year 1990 to 1994; second, an analysis of President Reagan's budgetary proposals for fiscal year 1990.

Much of the key information from these reports in terms of the budget numbers and economic assumptions is summarized in the committee's presentation that was prepared for these hearings.

My statement this morning covers the major areas discussed in our first report, the economic and budget outlook, including the economic consequences of large deficits, Mr. Chairman, I will submit my statement for the record and concentrate my oral remarks on our budget estimates.

Chairman **Rostenkowski**. Without objection, the entire testimony of all three of you will be included in the record.

If you each care to summarize, it is perfectly all right.

Mr. **Blum**. Turning to our baseline budget projections, which are summarized in the committee print as well as in page 1 of my prepared statement, the deficit for the current budget year is $159 billion and then it falls to $146 billion for both 1990 and 1991, slowly tailing off to $130 billion by 1994.

In making these baseline projections, we are using the specifications for baseline estimates in the Balanced Budget Reaffirmation Act, known as the Gramm-Rudman-Hollings Act, together with CBO's economic assumptions.

These projections, as I am sure the committee is well aware, contrast with those of the Office of Management and Budget and their current services projections which were part of President Reagan's budget.

This also is shown in table 1, in the committee print. The differences between these two sets of baseline projections are largely due to different economic assumptions.

These are compared in the committee print in tables 2 and 3 and also in our analysis of the President's budget.

CBO's economic forecast is essentially tied to the view that the economy is now close to full use of its productive resources. It is unlikely, therefore, in our view, that sustained rapid economic growth will occur and provide a means of closing the gap between outlays and receipts.

With the economy operating at a high level of capacity, the prospect of lower inflation appears remote. Because of the Federal Reserve's stated intention to restrain the economy, sharp declines in nominal interest rates are not likely in the near term.

CBO's forecast is similar to the average of private forecasters as contained in the monthly Blue Chip survey. We do not see a recession in the next few years.

Many private forecasters do, however. In fact, the majority of the forecasters in the Blue Chip survey do see a recession beginning in either 1989 or 1990.

In contrast, the Reagan budget forecast is much more optimistic, particularly as it affects the budget estimates.

Its optimism grows in the longer term beyond 1990. Substituting our economic assumptions for those underlying the Reagan budget clearly gives us different budget outcomes.

We have agreed that the outlook for 1989 is roughly a deficit of on the order of $160 billion, but for 1990, instead of a deficit of $92.5 billion as contained in the President's budget, we see under the Reagan administration's policies a deficit more on the order of $120 billion.

These re-estimates are even larger in the out years. In fact, they grow to close to $100 billion difference by 1994.

Some analysts concluded that the deficit is not a problem. I am sure the committee has heard testimony on this over the previous 2 days.

Over the last 6 years we have had continued expansion. Moreover, the deficit has declined as a percentage of GNP from a high of 6 percent down to 3 percent. This view overlooks, however, the amount of private savings that the deficit is absorbing.

The high rate at which domestic savings is being absorbed is the primary reason for concern about sustained large budget deficits.

This high rate means that the deficit restricts national saving and investment, reducing the prospects for future economic growth and with it the growth of living standards for later generations. Sustained deficits also raise interest rates, increase the trade deficit and increase the likelihood of severe swings in the financial markets. These points are elaborated on in my prepared statement and also in our annual report.

The concern over the decline in national saving and investment is motivated in large part by the expected changes in the age composition of the population as we look down the road, particularly early into the 21st century.

An increasing number of analysts are arguing we should be saving and investing more in the near term so there can be more capital and income available to ease the transition to an aging population and the retirement of the baby boom generation.

The best way to increase national saving, we believe, is to reduce the Federal deficit. This should have significant long-run effects on economic growth, although there can be some short-run costs.

In the end, it is essentially a political choice, to decide whether the future benefits would justify sacrificing near-term consumption.

With that, Mr. Chairman, I conclude my remarks.

[The statement of Mr. Blum follows:]

Statement of
James L. Blum
Acting Director
Congressional Budget Office

Mr. Chairman, I am pleased to appear before the committee this morning to discuss the federal budget outlook and the economic consequences of large budget deficits. These important issues are discussed in detail in the Congressional Budget Office (CBO) report entitled *The Economic and Budget Outlook: Fiscal Years 1990-1994*, which was released late last month. My testimony today will cover three major areas discussed in that report:

- The budget outlook;
- The economic consequences of large deficits; and
- Fiscal policy and the financing of Social Security.

THE BUDGET DEFICIT: THE OUTLOOK AND SOME HISTORICAL PERSPECTIVE

CBO now estimates the budget deficit for 1989 to be $159 billion, slightly higher than it was in 1988. Under current budgetary policies, the deficit is projected to decline slowly thereafter--to $146 billion in 1990 and 1991, $140 billion in 1992 and $130 billion in 1994--as shown in Table 1. These figures exceed by increasing amounts the deficit targets specified in the Balanced Budget Reaffirmation Act of 1987, which calls for a balanced budget by 1993. The budget baseline is estimated using methods prescribed in the Reaffirmation Act. It projects revenues, offsetting receipts, and entitlement spending under current laws, while defense and nondefense discretionary appropriations are held constant in real terms. To reflect new information provided in the President's budget and elsewhere, the budget estimates presented here have been slightly revised from those in our recent report (*The Economic and Budget Outlook*).

The size of future budget deficits depends heavily on how the economy will perform, particularly in the areas of economic growth, inflation, and interest rates. In CBO's view, the economy is now close to a full use of its productive resources. It is unlikely, therefore, that sustained rapid economic growth will occur and provide a means of closing the gap between outlays and receipts. With the economy operating at such high levels of capacity, the prospect of lower inflation appears remote. Moreover, because of the Federal Reserve's stated intention to restrain the economy, sharp declines in nominal interest rates are not likely in the near term.

As shown in Figure 1, the federal deficit has recently declined as a percentage of GNP, after rising sharply in the early 1980s. In the 1970s, the deficit averaged about 2 percent of GNP, but in the 1980s the deficit share has averaged about 4 percent. The deficit peaked in 1983 at about 6 percent of GNP, and has since declined to approximately 3 percent. Under the CBO baseline, the deficit-to-GNP ratio declines gradually to about 1.9 percent in 1994. The federal debt-to-GNP ratio is currently at or near a peak, and would fall gradually during the projection period (see Figure 2).

Some analysts conclude ~~that~~ because the deficit has recently declined significantly as a share of GNP, it no longer represents a serious problem. This view overlooks, however, the amount of private saving that the deficit is absorbing. Because domestic private saving has recently declined as a percentage of national income, the deficit is still absorbing as large a share of saving as in the early 1980s.

ECONOMIC CONSEQUENCES OF LARGE DEFICITS

The high rate at which domestic saving is being absorbed is the primary reason for concern about sustained large budget deficits. This high rate means that the deficit restricts national saving and investment, thereby reducing economic growth and with it the growth of living standards for later generations. Sustained deficits also raise interest rates, increase the trade deficit, and increase the likelihood of severe swings in financial markets.

Effect of Deficits on Saving, Investment, and Living Standards

Net saving and investment have declined significantly as shares of national income in the 1980s, and the federal deficit has been a significant factor. Since 1980, net

TABLE 1. BASELINE BUDGET PROJECTIONS AND UNDERLYING ASSUMPTIONS

	1988	1989	1990	1991	1992	1993	1994
Budget Projections (By fiscal year)							
In Billions of Dollars[a]							
Revenues	909	983	1,069	1,140	1,209	1,280	1,359
Outlays	1,064	1,142	1,215	1,287	1,348	1,416	1,489
Deficit	155	159	146	146	140	135	130
Deficit Targets[b]	144	136	100	64	28	0	--
As a Percentage of GNP[a]							
Revenues	19.0	19.2	19.6	19.6	19.5	19.5	19.4
Outlays	22.3	22.3	22.3	22.1	21.8	21.5	21.2
Deficit	3.2	3.1	2.7	2.5	2.3	2.1	1.9
Economic Assumptions (By calendar year)							
GNP (Billions of current dollars)	4,859	5,209	5,542	5,902	6,281	6,685	7,117
Real GNP Growth (Percent change)	3.8	2.9	2.1	2.2	2.2	2.3	2.3
Implicit GNP Deflator (Percent change)	3.4	4.2	4.2	4.2	4.1	4.1	4.1
CPI-W (Percent change)	4.0	4.9	4.9	4.6	4.4	4.4	4.4
Civilian Unemployment Rate (Percent)	5.5	5.5	5.5	5.5	5.6	5.6	5.6
Three-Month Treasury Bill Rate (Percent)	6.7	7.9	7.1	6.7	6.4	6.1	5.9
Ten-Year Government Note Rate (Percent)	8.9	9.3	9.0	8.6	8.1	7.7	7.4

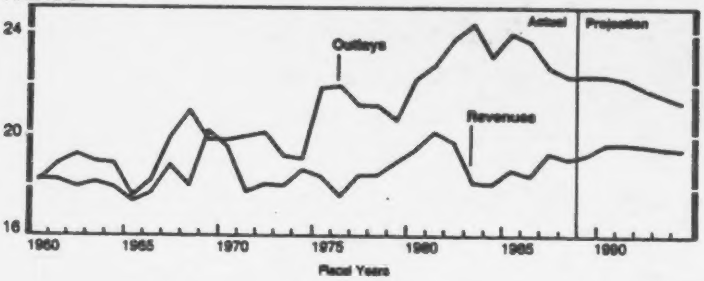
SOURCE: Congressional Budget Office.

a. The baseline projections include Social Security, which is off-budget.

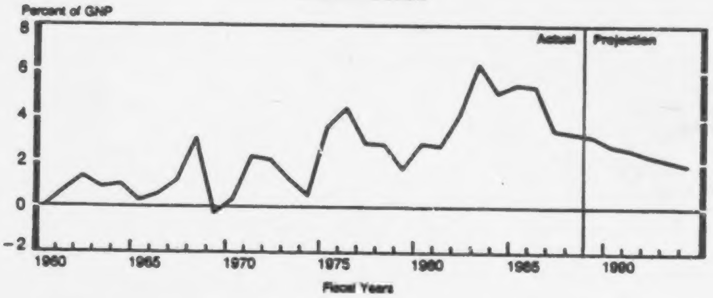
b. The Balanced Budget and Emergency Deficit Control Reaffirmation Act of 1987 established targets for 1988 through 1993.

Figure 1. Federal Budget Measures

Baseline Revenues and Outlays

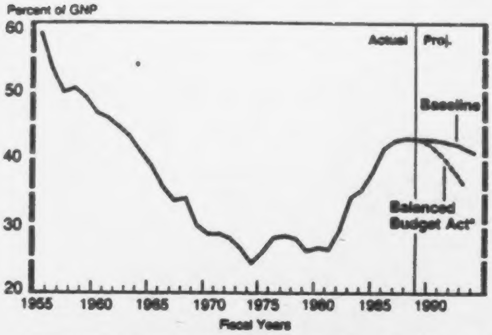


Federal Deficit



SOURCES: Congressional Budget Office; Office of Management and Budget; Department of Commerce, Bureau of Economic Analysis.

Figure 2. Publicly Held Federal Debt



SOURCES: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis.

[a] These projections assume full implementation of whatever deficit reductions are needed to achieve the budget targets for 1990 through 1993 set forth in the Balanced Budget and Emergency Deficit Control Reaffirmation Act of 1987.

national saving has averaged only 3.5 percent of net national product (GNP less capital depreciation) compared with 8.0 percent in the 1952-1979 period. Net domestic investment has also declined in the 1980s to 5.2 percent of net national product (NNP), compared with 7.6 percent in the 1952-1979 period. A net inflow of foreign capital has made up this discrepancy between saving and investment.

One can attribute the decline in the national saving rate about equally to declines in the net private saving rate and in the saving rate of the public sector. As Figure 3 shows, the private saving rate has fallen sharply during the 1980s. Moreover, according to most analyses of private saving, no significant improvement is likely soon. At the same time, as shown in Figure 4, the public saving rate has also fallen dramatically as a result of the rise in the federal deficit. Thus, absorption of saving by the public sector--the federal deficit less state and local government surpluses--has been a major factor in the recent decline of the national saving rate.

These trends in saving and investment are especially worrisome because recent rates of productivity growth and demographic factors imply that American living standards may improve less rapidly during the next half-century than in the past. A low national saving rate makes the slowdown worse. In large part, this slower growth will be caused by the retirement of the baby-boom generation early in the next century. A smaller part of the population will be working then, and what they earn will have to be shared with the increasing part of the population who will be retired. As a result, consumption per capita may grow significantly more slowly during the next half-century than during the last fifty years. Moreover, if saving rates and growth of productivity were to remain below historical averages, as they have recently, consumption per person would grow even more slowly.

Reducing the budget deficit would be the most direct way to increase saving. Policy measures may not be very effective in raising the private saving rate. Most proposed measures to increase private saving involve raising its after-tax real return--by cutting tax rates, for example. There is little evidence, however, that saving is responsive to the size of its return. During the first half of the 1980s, for instance, real interest rates rose sharply compared with the 1970s, marginal tax rates were cut, and several other policy measures were adopted to encourage saving. The private saving rate, however, failed to rise.

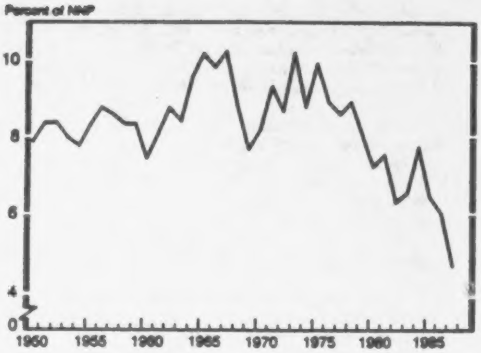
Significant deficit reductions can improve the outlook for increasing living standards. Recent analysis by CBO, which is described in our annual report, suggests that reducing the federal budget deficit beyond the reductions mandated in the Reaffirmation Act could raise consumption over the longer run. If the federal government were to run a surplus of 2 percent of GNP after 1993 instead of a balance, private and public consumption would initially be reduced by a little more than 2 percent, as the government reduced spending or increased taxes. But the higher saving would raise capital accumulation and output, and would eventually increase incomes and consumption. By the year 2040, for example, the increase in per capita consumption would be between 2 percent and 14 percent relative to what it would have been without the federal budget surplus assumed in the calculation. In CBO's view, the effect would be somewhere in the middle of this range.

How the deficit is reduced can have some impact on the gains in living standards that ultimately result. Certain federal expenditures on public investment --such as infrastructure, education, or research and development--may do as much as private investment to increase output, and could be given priority for that reason. If taxes have to be raised, however, most methods of broadening the tax base would better serve the process of encouraging economic growth than would an increase in marginal income tax rates. Other possibilities include a broad-based consumption tax, which could encourage saving, or an increase in excise taxes. An increase in the gasoline tax could, in addition to raising revenues, encourage conservation.

Effects of the Budget Deficit on the Trade Deficit

During the 1980s, the United States has experienced unusually large trade deficits, and an associated massive buildup of net U.S. debt to the rest of the world. The trade deficits are the products of several factors acting together, but the budget deficit is one of the main factors. As Figure 5 shows, the U.S. nominal trade deficit finally started to improve in 1987 and 1988. Recently, the improvement appears to have slowed, though CBO's analysis suggests that it will start to improve again if the dollar depreciates significantly further as the CBO projection assumes.

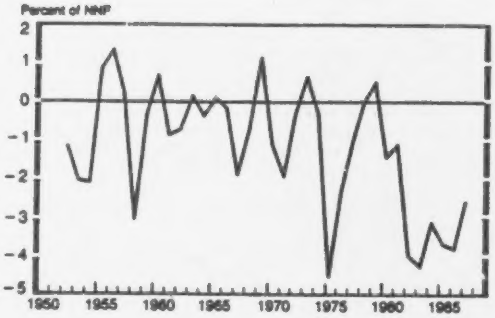
Figure 3. Net Private Saving as a Share of Net National Product



SOURCES: Congressional Budget Office; Federal Reserve Board; Department of Commerce, Bureau of Economic Analysis.

NOTE: Net private saving is private saving less depreciation of capital.

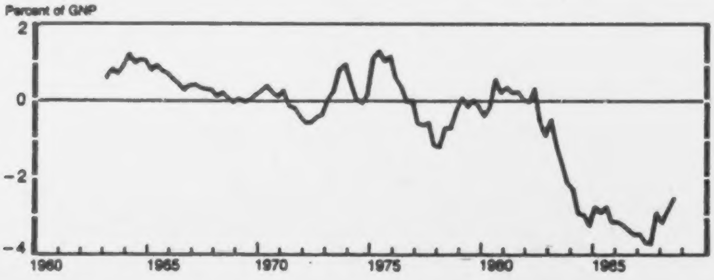
Figure 4. Public Saving as a Share of Net National Product



SOURCES: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis.

NOTE: Public saving is the sum of federal, state, and local government saving.

Figure 5. Current Account Surplus



SOURCES: Congressional Budget Office; Department of Commerce, Bureau of the Census, Bureau of Economic Analysis.

Reducing the budget deficit could play a critical role in reducing our trade problems. It could help lower the trade deficit by reducing domestic demand for imports, by freeing resources that could be used to expand exports, and by helping to cause the exchange rate to depreciate somewhat further. A budget deficit reduction path, like that contained in the Reaffirmation Act, would significantly improve the trade deficit over a period of several years.

Effects of the Buildup of External Debt

The buildup in the net U.S. debt to the rest of the world reached approximately one-half trillion dollars by the end of 1988, and is expected to reach $1 trillion by the mid 1990s. This buildup of debt brings with it two major economic problems: it means that increasing amounts of domestic income must be sent abroad as interest and dividends on foreign investments in this country, and that the United States faces an increased risk of a sharp decline in the dollar and a rise in interest rates. Some economists argue that these swings in interest and exchange rates could be severe enough to cause a recession.

The cost of servicing the foreign debt is mounting. At the beginning of the 1980s, the United States had net earnings on its foreign investments of about $35 billion per year. By 1988, however, the net earnings had gone, and we were instead paying abroad about $3 billion per year. If the net foreign debt grows to $1 trillion by the mid-1990s, as CBO currently projects, the cost of servicing the foreign debt could amount to some one-half percent of gross domestic product.

This buildup of external debt also poses increased risks to the U.S. economy. For one thing, foreign private investors and central banks may be increasingly unwilling to continue to finance U.S. current-account deficits. Inducing private investors to devote larger and larger amounts of their wealth to dollar investments may require progressively higher interest rates, as well as continued expectations that the exchange rate will not depreciate sharply.

Another risk is that foreign central banks may not be as willing to help finance our trade deficit as they have in the recent past. In the last few years, central banks abroad have at times devoted large sums to supporting the dollar. If this pattern continues, their countries could suffer potentially inflationary increases in their own domestic money supplies as a result.

Effect of Deficits on Interest Rates

Many analysts argue that large federal deficits are partly responsible for the unusually high levels of inflation-adjusted interest rates during the 1980s. The real 91-day Treasury bill rate has averaged 4.4 percent since 1980, compared with its average over the entire post- World War II period of 0.7 percent. The increased budget deficits during this period could have helped to raise rates by increasing competition with private demands for credit.

Economists do not agree on just how much interest rates would fall if the deficit were reduced. The decline in rates could be less dramatic than some have suggested because of the changes in net international capital flows that it might cause. In effect, the decline in interest rates may be attenuated because the effects are spread worldwide. The best chance of causing a large decline in long-term rates would come from a large and highly credible deficit reduction, perhaps phased in over more than one year. This approach stands the best chance of changing expectations in financial markets, which play a large role in setting long-term rates.

At the request of the National Economic Commission, CBO recently simulated the effects of reducing the budget deficit on interest rates using large-scale econometric models. Each package analyzed consisted of a multiyear program of reductions totaling $120 billion to $130 billion per year by 1994. This analysis suggested that the real interest rate might be about one and one-half percentage points lower on average over the five-year period, compared with the current baseline in the models. The reduction would be smaller in relation to CBO's baseline as shown in Table 1. These estimates also incorporate the effects of easing monetary policy. They are near the middle of the range obtained by other researchers using a variety of estimating techniques that take account of such refinements as effects of deficit reduction on the world economy and the implications of rational expectations.

The above estimates could understate the impact of deficit reduction on long-term interest rates if a large, multiyear deficit reduction is enacted. Some analysts have obtained substantially larger effects on long-term rates by using analytic methods that emphasize rapid changes in expectations, such as those that could bring long-term rates down sharply. On the other hand, as I discussed earlier, there is a risk that the decline in interest rates may be smaller because of the response of international capital flows and the trade deficit. Thus, a major benefit from reducing the budget deficit may be an improvement in the balance of payments, rather than a large effect on interest rates. Many analysts stress the effects on the balance-of-trade, and above all the effects on long-term economic growth, as the principal benefits from reducing the deficit.

Short-Run Effects of Cutting the Deficit on Aggregate Demand

My testimony so far has focused primarily on the long-run consequences of fiscal policy. I have argued that reducing the deficit and eventually running a budget surplus would increase long-run growth by increasing saving and investment. But I should also point out that in the short-run reducing the deficit can temporarily have the opposite effect on economic growth--that is, it can reduce aggregate demand and cause unemployment to rise. Some policymakers are especially concerned that, with the expansion beginning its seventh year, now may not be an opportune time to reduce fiscal deficits.

In the current circumstances, however, it seems unlikely that deficit reductions of the magnitude contemplated in the Reaffirmation Act would run a major risk of causing the economy to be too weak. Aggregate demand has recently been too strong to suit the Federal Reserve, and has prompted significant monetary restraint. Significant deficit reduction could make less monetary restraint possible. In addition, a budget plan that convincingly sets a course of declining deficits over several years could, as I explained earlier, have a quick and substantial effect on exchange rates and long-term interest rates. That effect, in turn, could stimulate other sectors of the economy and help avoid causing an economic slowdown.

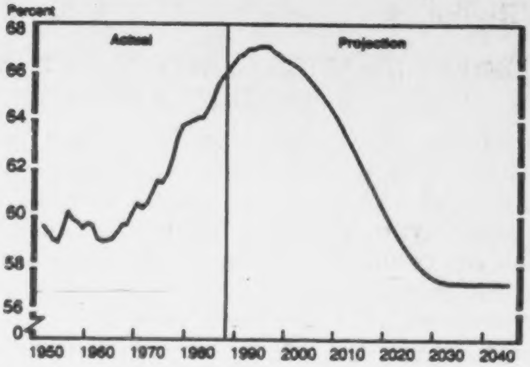
FISCAL POLICY AND THE FINANCING OF SOCIAL SECURITY

Some arguments for reducing the deficit are bound up with developments involving expected changes in the age composition of the population. As Figure 6 illustrates, the Social Security Administration's long-term demographic projections indicate that the share of the adult population (ages 16 and older) in the labor force will begin a permanent decline at about the turn of the century as the baby-boom generation reaches retirement age.

These long-term projections are valuable because they illustrate the need to plan ahead for the major rise in the ratio of people who are dependent. A major implication of this change is that the economy and the population who are then working will have to support a large retired population. Some analysts argue that we should start saving and investing more in the near term so that more capital and income will be available to ease this transition and to help support a much larger retired population. As I mentioned earlier, such calls for increased national saving usually take the form of recommendations that the federal budget deficit be reduced.

The Social Security trust fund is currently running a surplus of over $50 billion per year as a result of the Social Security reforms of 1977 and 1983. Because of past and projected surpluses, the projected buildup in Social Security balances is very large--from slightly over $100 billion at the end of 1988 to about $9.1 trillion by the year 2020. By that time, program outlays will exceed payroll tax receipts for Social Security. As a result, the overall federal deficit will grow sharply. Many analysts would argue, therefore, that the right time to increase government saving is during the next 30 years. In that way, fiscal policy would be contributing to capital formation. Later, it will be more difficult.

Figure 6. Labor Force as a Share of the Adult Population



SOURCES: Congressional Budget Office; Social Security Administration.

CONCLUSION

In conclusion, large budget deficits exacerbate several major problems of the economy: a low saving rate; a large trade deficit and mounting foreign debt; and an element of instability in financial markets. The Congress has made significant progress in reducing the fiscal deficit. As a result, the deficit problem has become more chronic than acute. Further substantial cuts in the deficit could have significant long-run effects on growth. Economic analysis can only help inform the debate; it remains, however, essentially a political choice to decide whether the future benefits justify the sacrifices they would entail.

Chairman ROSTENKOWSKI. Thank you.
Ms. Rivlin.

STATEMENT OF ALICE M. RIVLIN, PH.D., SENIOR FELLOW, THE BROOKINGS INSTITUTION

Ms. RIVLIN. Mr. Chairman, I am happy to be back before the Ways and Means Committee to discuss the outlook for the U.S. economy and the Federal budget deficit. I am particularly glad that, before you immerse yourselves again in the details of the complex array of tax and spending programs under the jurisdiction of this committee, you are taking a moment to look at the broader picture into which those programs fit.

Recent preoccupation with reaching the Gramm-Rudman-Hollings targets for the budget deficit has made it more difficult than usual to look beyond the upcoming fiscal year. Concern about getting past the next annual deficit target tends to eclipse the ultimate objective of this agony: Improving the chances that we will have a healthy, prosperous American economy in the future. It seems particularly important, therefore, at the beginning of consideration of the first budget of a new decade, to ask, "What do we want for the American economy in the 1990's and what economic policy changes would help achieve those ends?"

There is really no dispute about the goals. Everyone wants an economy that is growing at a healthy sustainable rate—such as 2 or 3 percent real increase in the gross national product per year on the average—with no more than moderate rates of inflation—say, no more than about 4 percent increase in prices per year.

Indeed, we all know that unless we achieve something like this on the average, we will not be able to afford both rising private levels of living and an improved quality of public services. Nor will we be able to play the leadership role on the world scene that all of us want to see our country play.

By these standards, economic performance since the deep recession of the early 1980's, has been a success. We have had an unusually long period of economic growth. Employment has risen, unemployment has declined, and a record proportion of the population now hold jobs. Inflation, which was so worrisome in the 1970's, has been quite restrained.

Relatively low energy prices and other special factors helped, but many economists are still surprised that unemployment fell to such low levels without igniting a spiral of rising wages followed by higher prices and self-fulfilling expectations of future inflation.

It is true that not all have shared in the improved economy and that income inequality has increased. It is also true that to a large extent, recent prosperity has been built on borrowed funds, both private and public, of which the most worrisome part is growing American indebtedness to the rest of the world.

Even with respect to deficits and debt, however, recent progress is discernible. The budget deficit, which ran well over $200 billion for several years and was projected to exceed $300 billion if policies were not changed, has been brought down to $155 billion. That reduction did not just happen, as this committee knows full well.

Getting the deficit on a downward track took a combination of tax increases, halting the defense spending growth, and severely restraining domestic programs. Even the budget deficit's twin, the trade deficit, has begun to come down. We are still borrowing a great deal abroad—and pay increasing debt service to foreigners—but we are a rich country that can afford to borrow far more than Third World nations can.

The real question is: Will the good news continue as we move into the 1990's or do we need substantial changes in policy to insure continued growth?

The basic fact is that we are facing a new situation in the 1990's: The end of the period in which we could grow primarily by putting more people to work. Much of the growth of the American economy in the 1970's was attributable to rapid increases in the labor force—the baby boom generation reaching working age and married women coming into the paid labor force in increasing numbers.

In the last few years, a substantial share of the growth has reflected new jobs for those who had been unemployed or were not in the labor force because they thought they could not find work. Now, however, we are entering a period in which relatively small numbers of young people will be reaching working age.

Moreover, high proportions of adult women are already working, and unemployment cannot be reduced much more without serious danger of escalating inflation.

Hence, if total product is to rise, existing workers will have to be more productive. The productivity increase becomes especially imperative as the baby boom generation reaches retirement in the first quarter of the 21st century. The relatively small labor force of that period will have to be substantially more productive if they are to achieve a rising standard of living for themselves at the same time that they pay rising benefits to the large population of retirees.

Raising worker productivity will not be simple or easy. It will take a national effort to increase research and develop new technologies, to improve plant and equipment and basic infrastructure and, probably most important, to improve the skills, training, knowledge, and adaptability of workers themselves.

These efforts have one thing in common: They require that we consume less and save more so that we will have the resources to invest in the Nation's physical, human and intellectual capital. Some of the investment should be in the private sector and some in the public.

But, whichever way we do it, if we are to live better in the future, we will have to consume less as a nation, and channel those savings into productive investments.

Saving can come from individuals, corporations, and other private institutions consuming less than their current income. Or, it can come from Government running a surplus and reducing its indebtedness.

The United States has never been a high saving country, but in the 1980's, our national saving rate has plummeted, both because the private saving rate has declined substantially and because public saving has been strongly negative due to the large deficit in the unified Federal budget.

The dearth of saving has meant high real interest rates and would have meant even higher ones if we had not been able to borrow the savings of foreigners. This dependence on foreign saving, however, is precarious in the short-run and expensive in the long-run.

The first steps toward insuring a growing American economy in the 1990's and beyond, is to get our national saving rate up by increasing both private and public saving. It is not at all clear that we know which public policy levers would be effective in raising private saving.

We do, however, know exactly how to increase public saving. We must bring the Federal deficit down to zero and then move the unified budget into surplus.

I realize that I am preaching to the choir. This committee has shown clearly that it understands the need for increasing saving in the public sector.

You took the actions necessary to put the Social Security system on a sounder footing and to generate the surpluses that are now building up in the Social Security trust fund. But those surpluses will do nothing to increase the future strength of the economy if they are simply used to pay the current expenses of the rest of the government.

Using the Social Security surplus in this way is analogous to allowing a corporation to spend the employees' pension fund for current operating expenses rather than investing it prudently for future use.

This committee's stewardship of the Social Security benefits of future retirees must extent beyond accumulating reserves in the Social Security trust fund. If you are to carry out those stewardship responsibilities, you must work with your colleagues, first to meet the targets of Gramm-Rudman-Hollings, but then to move the unified budget into substantial surplus.

Then at least part of the surpluses in the Social Security trust funds can be used to reduce the Federal debt held by the public, thus putting downward pressure on interest rates and channeling more funds into productive investment.

Whether Social Security is considered technically on budget or off budget is of little importance as long as the Social Security surplus is being used to finance part or all of the gap between the general services Americans want from their Government and the general revenues that pay for them.

Somehow we need to move the unified budget into surplus so that the Federal Government as a whole becomes a net contributor to national saving, not a reducer of these savings.

Does this mean that we should remove Social Security entirely from the conversation about fiscal policy—as though it exited on some other planet—and aim for balance in the rest of the budget? I doubt that this is really possible or even desirable.

Part of the investment that we need to raise future productivity must take the form of improvements in public infrastructure and the kinds of investment in human and intellectual capital that can best be done by some level of government for instance, support of basic research, education, training, et cetera.

If we had well-thought-out plans to increase those public investments, either at the Federal or at the State and local level, it would certainly be a legitimate use of Social Security surpluses to fund or offset those investments. The point is that we must think of the Social Security trust fund surpluses as savings to be invested either privately (through the reduction of public debt) or publicly in ways that will increase future productivity and the future national product from which the Social Security benefits of the next century will be paid. It seems to me the special responsibility of this Committee to help the rest of the Congress understand why this objective is so important.

In the short run, of course, reaching the Gramm-Rudman-Hollings target of balancing the unified budget by fiscal year 1993, will be difficult enough. The optimistic assumptions of the Administration about growth and interest rates may make the job look easier this year, but are likely only to make it more difficult next year. If revenues are not to be raised, substantial cuts must be made in spending. Because the programs to finance medical care fall under the jurisdiction of this Committee, and because medical costs are still rising so much more rapidly than other costs, some of the most difficult decisions will necessarily be made right here.

In short, Mr. Chairman, I believe that the chances for continued economic growth in the 1990's are good, but success will depend on keeping long run goals firmly in mind. A primary national goal must be to raise the national saving rate. The Congress, with the leadership of this Committee, has already created a mechanism by which the Federal Government could contribute substantially to needed national saving by running a surplus in the Social Security trust fund. The task that remains, however, is to move the rest of the budget closer to balance and achieve a surplus in the unified budget.

May I close with a word about the politics of the situation. We sometimes imagine that concern of the future involves trading off the interests of faceless unborn generations against those of current voters. Those with most interest in prudent use of the Social Security reserves, however, are the baby boom generation. These people are already adults. They have jobs; they vote; they run for Congress.

If they are not pressuring you to protect their retirement benefits by running a surplus in the unified budget, it is only because they do not yet understand how much they have at stake.

Thank you, Mr. Chairman.

STATEMENT OF RUDOLPH G. PENNER, PH.D., SENIOR FELLOW, THE URBAN INSTITUTE

Mr. PENNER. Thank you, Mr. Chairman. It is a great pleasure to be here.

I shall summarize my overly long statement very briefly.

The economy has been behaving extremely well as we are entering our 7th year of a recovery, but demand has been growing a little bit too fast. As a result, inflation has been accelerating but only by a very small amount.

The Federal Reserve has appropriately been gradually tightening monetary policy. While this is the right thing to do, it will make it extremely difficult to obtain the economic growth rates underlying the administration's growth rate projection and CBO's projections could be a bit optimistic. This will make it extremely difficult to actually meet the Gramm-Rudman-Hollings targets for fiscal year 1990.

However, any deficit reduction that can be accomplished will be useful in the short- and long-run. In the short-run it will greatly ease the task of monetary policy by allowing the same restraint and demand growth with lower shortrun interest rates.

Although, as Jim Blum noted, it has become stylish to say deficits don't matter much, and although it is true that the risk that the deficit will cause some sort of trauma have been reduced by recent deficit-reducing actions such as significant spending constraint since 1981, the whole series of tax increases that this committee has courageously put through since mid-1982 and, of course, by the long economic recovery, further deficit reduction is crucial, in my view, for the longer run.

We are saving very little privately, as Alice noted, and we are using scarce private saving to finance a huge budget deficit. As a result, the net wealth of the Nation is growing slowly and our descendants are being left with little to improve their standard of living.

If the United States grows slowly in the future, its relative military power will wane as well as our influence in international bargaining over issues of economic policy. I think that we owe our descendants a better legacy.

But the debate over the deficit is complicated and difficult to resolve. Experts disagree about the exact effects of the deficit.

More important, the Nation is not only debating the deficit but rather it is also simultaneously debating the appropriate role for the Federal Government in our society. I, like Alice, like to view these budget problems in the context of the very long run.

I believe for the last 20 years the Nation has been floundering over an attempt to achieve for mutually inconsistent goals. We have attempted to maintain a strong defense, we have tried to fulfill large promises to a rapidly growing elderly population and to the disabled. All that while, we have been attempting to keep tax burdens and deficit levels down toward what was experienced in the early 1960's.

The most important fact about the budget, as you all well know, is that over 75 percent of spending goes to defense, the elderly and disabled or to paying interest on the national debt.

In the late 1960's and early 1970's the promises to the elderly were increased greatly with the invention of medicare and its rapid growth and very large real increases in Social Security benefits. At first these quasi-permanent promises to the elderly were financed with a resource that had to be temporary, defense cuts after the Vietnam war. When defense had to be increased again in the late 1970's, tax burdens were allowed to drift upward as inflation pushed people into higher tax brackets.

We then saw the tax revolts. We elected an anti-tax President, and we had very large tax cuts. Defense spending was accelerated and the deficit soared. Recently we have come full circle.

We are again making progress on the deficit, but, in part, through cutting defense, something that can't go on forever. Eventually something fundamental has to give.

Unfortunately for reasons described in my testimony in detail, the fundamental debate can be postponed for a long time. But these issues will have to be faced early in the 21st century when the elderly population begins to grow rapidly again, and it would be very useful to have the debate now so that we can engage in some long-run planning.

Either we shall have to reexamine our role in the world so that our defense burden can be eased or promises to the elderly will have to be reexamined or we shall have to be ready to accept major tax increases that will bring the overall tax burden to record levels.

In the shorter run the constraints are formidable. I find it difficult to advise the President to causually yield on his no tax pledge which was so firmly given to the American people. Without tax increases, I also find it difficult to seek politically plausible opportunities for the deficit reduction that I think we badly need.

It may be relatively easy to satisfy Gramm-Rudman on paper, but the strong incentives provided by that law to adopt optimistic assumptions are its greatest weakness. I believe that it conveys far too much power to the executive branch because they get to choose the assumptions that drive all that follows.

It may be a good time for the Congress to take a fundamental look at the budget process including Gramm-Rudman-Hollings. I suspect that you will have to before the debate on fiscal year 1991, in any case.

In a recent book, Alan Abramson and I suggest mechanisms for formalizing the dynamics of recent summit agreements that have been somewhat successful in the deficit reduction that has occurred in recent years.

The proposals would enhance the power of the congressional leadership and the President in the budget process. Congress may be reluctant to grant the President more power, but our proposals, which I would be pleased to discuss in detail, would transfer far less power than is inherent in the current Gramm-Rudman-Hollings.

Thank you very much.

[The statement of Mr. Penner follows:]

STATEMENT OF RUDOLPH G. PENNER*
SENIOR FELLOW THE URBAN INSTITUTE

Mr. Chairman and members of the committee, I would like to thank you for this opportunity to testify on economic and budget issues.

The Economy

Since reaching its deepest post-World War II trough in 1982, the economy has performed admirably. We are beginning the seventh year of an extremely healthy recovery, manifested by the fact that inflationary pressures are still moderate. There are no obvious imbalances that signal that a recession is imminent, although it must be admitted that recessions are seldom recognized until after they begin.

The economy is, however, operating near, if not at, full capacity, and demand is expanding too rapidly by a very small margin. Chairman Greenspan has emphasized his concern about present rates of inflation and the Federal Reserve System is gradually tightening monetary policy. It is an environment that leaves little room for error. Too little tightness and inflation could accelerate to the point that it will be very painful to cure. Too much, and an economy that is not extremely strong could sink into recession. Under the circumstances, I believe that the Federal Reserve is doing as skillful a job as is possible.

I would like to see the Fed aim for about 6 percent nominal GNP growth over the next two years. That would maintain slight downward pressure on inflation. The Fed is not explicit about its goals, but it seems to me that current policy is, in very rough terms, consistent with this nominal GNP goal. If I am right, that is likely to allow much less real growth than is assumed by the administration in its budget projections and a bit less growth than is assumed by CBO. That would put actual attainment of the Gramm-Rudman targets beyond reach politically, but it will be much easier to reach them on paper using administration assumptions. With any good luck economically, that should still be true next August.

Any deficit reduction that can be enacted would be very helpful to the Federal Reserve. The same target for demand growth could then be achieved with lower short-term interest rates.

The Budget Deficit

It has suddenly become stylish to argue that budget deficits do not matter much. I believe that that is far from the truth, but it is easy to understand how such a belief could arise.

Those who warned that some sort of economic catastrophe would result from the deficit are said to have been proved wrong, because the economy has behaved so well. I would provide another interpretation. Those previously crying doom and gloom may or may not have been wrong analytically, but I would argue that we shall never know. Partly in response to worries about the budget policies of the early 1980s, policy was changed significantly. A steady series of tax increases since the middle of 1982 is providing extra revenue equivalent to almost 3 percent of the GNP. Spending restraint has been impressive both in the entitlement and discretionary civilian budget categories. And most important quantitatively for spending, budget authority for defense began to be cut in real terms by roughly 2 percent per year starting in fiscal 1986.

As a result of such actions and the prolonged, healthy economic recovery, the budget deficit has fallen, relative to GNP, from a high of 6.3 percent in fiscal 1983 to 3.2 percent in fiscal 1988. I, for one, am not nearly as concerned as I was in the mid-1980s after the interest bill on the debt rose 24 percent between 1983 and 1984, and the problem threatened to explode. More recently, the interest bill has been rising at less than half that rate and has a good chance of now stabilizing relative to GNP. The probability that an exploding interest bill will eventually force us to monetize the debt and cause a hyper-inflation has become miniscule.

Another fear of many is that the dependence on foreign capital inflows engendered by the budget deficit creates inherent instability in foreign exchange markets that could lead to a foreign exchange crisis. This possibility still exists, but my own worries about it have waned considerably since early 1988 when it became clear that we had satisfactorily weathered the storm caused by the October 1987 crash. I was also reassured when private foreign investors, who had greatly reduced lending to the United States during 1987, returned in 1988. Moreover, the trade and current account deficits improved considerably in 1988.

We are still, however, expecting foreign investors to add significantly to their balances of dollar assets in percentage terms this year and there are some signs that the improvement in our external balances is ending. Consequently, the probability of a foreign exchange crisis is greater than zero, but I believe that it is considerably lower than it was only one year ago.

However, saying that the budget deficit is unlikely to cause an economic crisis is far from saying that it is not harmful. It is, in fact, having highly undesirable effects, but they are occurring slowly rather than all at once. In fiscal 1988, the Federal deficit absorbed more than 60 percent of the nation's net private saving. This extraordinary ratio is a reflection both of the large relative size of the Federal deficit compared to those of past history and the unusually small amount of net private saving.

The low level of net private saving combined with the high level of the Federal deficit implies that the nation's stock of net wealth is growing very slowly and that our generation is leaving our descendents with much less capacity to improve their standard of living than our predecessors left us.

Moreover, our descendents will face a burden that we largely escaped. After the first decade of the 21st century, the ratio of the retired to working population will rise rapidly. Therefore, if the United States remains a low saving, high deficit society, income growth will be lower than it would be otherwise and a greater portion of the income growth will have to be transferred from the working to the retired population. Nevertheless, with any luck at all, future workers should still be better off than current workers. It is just that the rate of improvement from generation to generation will be much lower than the United States has been accustomed to in past history. The size of the American economy will decline more rapidly relative to the size of other economies and this is likely to weaken our long-run military influence and our international bargaining power in trade policy and other matters.

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*The views expressed are those of the author and do not necessarily reflect the views of the trustees, executives, or staff of the Urban Institute.

It all boils down to the question of what sort of country we wish to leave to our descendents and fundamentally, this is a moral question. I find it very difficult to come up with a moral rationale for doing much less for our descendents than our ancestors did for us.

Thinking About The Budget Strategically

Deficit reduction has been very difficult for two reasons. First, the pain involved is immediate in the form of program cuts or higher taxes while the gains take a very long time to accrue and are fairly nebulous. Second, the issues are extraordinarily complex and difficult to explain. That is because we are not only debating the effects of the deficit per se, but we are simultaneously debating the proper role of the Federal government in our society. Those who wish to solve the bulk of the deficit problem through spending cuts clearly want a smaller government that both provides few benefits and interferes in our lives very little. Those who want to solve the problem primarily by raising taxes are saying that they are satisfied with government's role the way it is, and some would expand spending further to provide new social benefits.

In debating the role of the Federal government, it is crucial to recognize that it has only three functions that cost a lot of money. It defends the country; it provides social insurance for the elderly and disabled; and it pays interest on the national debt. Total spending on these activities will account for over 75 percent of net outlays in fiscal 1989. Defense constitutes 26 percent of net outlays, and interest, 15 percent. Social security, military and civil service pensions, and medicare account for 34 percent of net spending. In addition, a considerable portion of medicaid, housing subsidies and nutritional assistance goes to the elderly.

None of the above is meant to imply that budget functions other than defense and caring for the elderly are unimportant. It is just that none of the multitude of programs in the rest of the budget costs very much individually, and therefore, cuts in such programs, however radical, cannot play a large role in deficit reduction. Other programs should still be scrutinized, but it is impossible to think of major changes in the future path of total spending that do not involve defense or payments to the elderly and disabled.

Indeed, much of the fiscal history of the last 20 years can be thought of as a struggle to fulfill four mutually incompatible goals. They are maintaining a strong defense, keeping the promises to the elderly inherent in various entitlement laws, and keeping budget deficits and tax burdens from rising much above the levels of the early 1960s. Oversimplifying that history considerably, it can be said that the beginnings of the conflict can be found in the late 1960s and early 1970s. It was in that era that medicare was invented and began to grow rapidly. Simultaneously, a series of real benefit increases converted the social security program from a minimal pension system to one large enough to be significant in the retirement planning of more affluent Americans. At first, the rapid growth in the cost of promises to the elderly was largely financed by the famous peace dividend as Vietnam defense spending was cut, and by a slight increase in the deficit. Payroll taxes were raised, but income taxes cut, and the total tax burden relative to GNP actually fell considerably between 1969 and 1974, partly as a result of ending the Vietnam surtax. Thus, we made the mistake of financing a quasi-permanent set of very expensive promises to the elderly largely with a source, defense cuts, that had to be temporary.

When the need to increase defense again became apparent in the late 1970s, the tax burden was allowed to rise for a time as the result of inflation, but public hostility to increasing Federal, state, and local tax burdens soared and we elected an anti-tax president. In 1981, the total Federal tax burden was cut back to levels only slightly higher than in the early 1960s and the defense buildup was accelerated. Although, a bit later, social security and the medicare payments system were reformed, the immediate outlay effect was small, the promises to the elderly remained virtually intact, and the deficit soared. Now, we are responding to the deficit problem, in part, by again cutting defense, something that cannot go on forever.

In other words, we have gone on for 20 years without explicitly admitting that we are pursuing inconsistent goals and that something important has to give. If the American people are truly resistant to any increase in the Federal tax burden above, say, 20 percent of the GNP, and if they want something approaching a balanced budget, then eventually, either our role in the world must be reexamined, so that defense can be cut significantly, or our promises to the elderly have to be reexamined, or both. Certainly, new major roles for the government in areas such as child care or long-term health care cannot be contemplated. Conversely, if the nation wishes to remain strong militarily and to maintain benefits to the elderly, as defined by current law, and if large new social programs are contemplated, then increases in the Federal tax burden to record levels must be contemplated in the longer run.

While I would like to see an explicit national debate on such issues, it is, unfortunately, easy to avoid. Eventually, the fundamental issues will have to be faced, but eventually can be a very long time away.

It is even possible to make considerable progress in reducing the deficit in the next ten years without explicitly facing these fundamental issues, but it will not be possible 20 years from now. Delay is now possible because of fortuitous circumstances, and because of the very long time horizon that has to be used in analyzing budget policy.

The most important fortuitous event is a slowing, through 2005, in the rate of growth of the elderly population because of the birth trough during the Great Depression. This eases budget pressures somewhat for the next 15 years. Ideally, this respite should be used to get our fiscal house in order and to make some fundamental decisions about policy changes for the period after 2005. Unfortunately, the respite also makes it possible to delay such decisions.

Another fortuitous event has not yet come to fruition and, at this point, it is not certain that it will occur, but if Gorbachev really reduces the intensity with which the Soviet Union pursues the military competition between the superpowers, considerable savings in defense should be possible. Even absent a fundamental change in military strategy, defense growth can be curbed for a good long while.

In a number of budget areas, I am always impressed at how long spending can be cut without undertaking a fundamental change in policy. Defense provides an excellent example of this phenomenon. Between 1980 and 1985 real defense outlays rose 7 percent per year. Now they are beginning to decline in real terms because of a lagged response to real cuts in budget authority beginning in fiscal 1986. However, it is difficult to perceive any significant difference in foreign policy or military strategy, or even military tactics, between the early 1980s and the late 1980s, even though spending policy changed radically. There would seem to be something wrong with this phenomenon, and indeed, there is. Investment has been cut disproportionately -- it always seems easy to cut investment in both the military and civilian budgets -- but few weapons systems have been eliminated. Purchases are being stretched out and some weapons are being produced at uneconomic rates. The military are basing long-term planning on the assumption that there will be real growth in budget authority when that seems highly unlikely. It is possible that we shall end up with unbalanced forces or return to the deplorable state of readiness existing in the late 1970s. It is to be hoped that some major changes in defense budget policy will be forthcoming from the Bush Administration, because recent approaches do not seem viable for the very long run.

A similar situation exists in medicare. Spending growth has been slowed significantly without major changes in the basic structure of the program. Considerable, justifiable savings have recently resulted from squeezing down payments to hospitals, and somewhat less successful attempts have been made to curb the growth of payments to physicians. However meritorious such reforms may be, they can only be successful in the short run. There are obvious limits to how much suppliers can be squeezed. And every time the squeeze is halted, the fundamental structure of the program reveals itself and outlays will again begin to grow at a real rate approximating 8 percent per year. Clearly, in the very long run, the basic structure of the program will have to be significantly reformed or Americans must be prepared to see their HI taxes steadily raised.

If, in the interest of keeping tax burdens relatively constant and maintaining a strong military establishment, significant changes in payments to the elderly were enacted, it is important to phase them in slowly, so that people have time to adjust their retirement plans and private savings. That, of course, means that not much immediate deficit reduction can result from such reforms. But if the rate of growth of payments to the elderly is slowed in the very long run, immediate deficit reduction becomes less urgent because the burdens faced by future workers will be lessened.

For an example of a significant reform, suppose that, for the period following 2009, the Congress decided to increase the normal retirement age under social security somewhat more rapidly than is contemplated in current law and to eventually raise it to age 70. Suppose, at the same time, the eligibility age for medicare was increased along with the normal retirement age. Nothing would be saved in the short run, but the current present value of future savings would be substantial. It is unfortunate that our current budget process cannot give a "deficit reduction" credit currently for that sort of reform. I would not advocate a formal process reform that would do that, because it would be too complicated and our process is already far too complicated. But it would certainly be legitimate, having enacted long-run savings, to adjust the deficit target upward as it is currently measured. Moreover, it would be important to actually enact such a change quickly, so that current workers would get plenty of warning about a change in the rules of the game.

Reasonable increases in the retirement age combined with an increased eligibility age for medicare would not be sufficient to, say, hold social security plus medicare to a constant share of GNP through the middle of the next century, and many other significant reforms would be necessary. It is simply not possible to maintain current tax burdens in the long run without accepting some very fundamental changes in what the Federal government does now and has promised for the future.

Conversely, it is impossible to continue into the long run fulfilling all of our promises and balancing the budget without raising taxes significantly. If this is to be our long-run approach, it is probably time to start thinking about developing a new source of revenues. Without a new revenue source, payroll and/or income tax rates will have to be raised substantially. That will increase the distortions created by these taxes and make them more difficult to administer. A new, broad based consumption tax would have considerable appeal as a substitute for such rate increases.

In between these two extreme strategies, one can contemplate lowering the growth rate of payments to the elderly less radically, reducing the size of our defense commitments, and raising taxes less dramatically. Past records for tax burdens would have to be breeched, but the needed revenues could probably be obtained within the current structure of the tax system without necessitating a brand new tax.

In accomplishing this goal, most economists would like to keep marginal tax rates as low as possible while broadening the tax base as much as possible, because it is the marginal tax burden on the last bit of private saving or work effort that creates disincentives and imposes efficiency costs. In broadening the base, I would also prefer to do so in a way that discourages consumption rather than saving. Some excise tax rate increases would also be required under this strategy.

This committee is well acquainted with the available excise tax and base broadening options, and I shall not discuss them in detail. There were essentially three potential tax bases left relatively unscathed by tax reform -- owner occupied housing, fringe benefits, and untaxed government benefits. All have large potential revenue yields.

Conclusion

I have, in this testimony, attempted to focus on some very fundamental issues that should dominate the debate over the Federal budget over the next decade. Unfortunately, that does not provide very specific guidance about what to do during this difficult budget year.

I would like to see a debate about the fundamentals begin, but the administration and the Congress are likely to adopt highly optimistic economic and other assumptions that suggest that there is not a fundamental problem. No economist can argue with certainty that these optimistic goals will not be attained in the long run, but no one would argue that a corporation should make its long run plans on the assumption that everything will work out just right. I do not think that the Congress should either. Unfortunately, Gramm-Rudman creates strong incentives for assuming the problem away. This is its most undesirable feature, but I am realistic enough to realize that it is extremely difficult to change this soon enough to affect fiscal 1990.. I also hesitate to suggest that the president casually yield on his "no tax" promise, because it was so firmly made to the American people. But if these constraints are accepted, progress on the deficit, that I believe is so urgently needed, will be modest.

I do believe that some is possible, however. The new administration seems willing to take a hard look at defense tactics, and perhaps, the cuts from current policy can be somewhat more efficient than those of the recent past. A bit more can probably be squeezed from medicare, and some of the program eliminations suggested by President Reagan should be examined carefully. It may also be possible to find some revenue increases that are too small to quack, especially in the user fee area.

In total, however, the constraints are formidable and they severely limit what can be accomplished this year. Looking forward, however, it seems clear that some of the constraints will have to be broken as we move toward fiscal 1991. If I am right about the economy and the limits on deficit reduction this year, the 1991 Gramm-Rudman target will be far from reach. It would be useful for the Congress to undertake a reexamination of this law early. The modifications undertaken because of the Supreme Court decision placed enormous power in the hands of the executive branch. This year, come August, the OMB has the power to assume that whatever the Congress does is consistent with the target or it can assume that it is a bit short of the target, thus forcing additional action to avoid a sequester. Or it can be sure that a sequester occurs.

It may be a good time to look at the entire budget process. In a recent book, Broken Purse Strings, Alan Abramson and I suggested that the process be modified in a way that formalizes recent summit arrangements that have been responsible for considerable deficit progress in the recent past. This would involve somewhat increasing the power of the president and the Congressional leadership in the budget process. However, the power of the president would be enhanced much less than is inherent in the current version of Gramm Rudman.

Perhaps, a deal is possible. One of the reasons that there is so much opposition to a tax increase is the worry that it will not go to deficit reduction, but that it will all be spent. Giving the president a bit more power to limit spending may dampen opposition to a tax increase. I am, of course, assuming that if we had the fundamental debate on what government does, as described above, the public and even the administration would opt for some tax increase to avoid the significant reduction in the government's current role and promises for the future that will be necessary if tax increases are ruled out for the long run.

Chairman **Rostenkowski**. This is a very informal, free discussion. If any of you would like to chime in to agree or disagree or add something, please feel free to do so.

Do any of you disagree that the assumptions made in this budget are a little bit rosy?

Do you really think that we can under the scenario that is going to be presented to us don't meet the goals of this administration *without revenues*?

Ms. **Rivlin**. I certainly agree that they are rosy. And the important thing to keep in mind is that they are inconsistent.

We might get growth rates as high as the administration is assuming or we might get reductions in interest rates as large as the administration is assuming. But we won't get both.

If the growth is going to continue, the Federal Reserve will insure that it leans against the wind, and the interest rates will go up.

Mr. **Penner**. Alan Greenspan said they are possible, almost anything is possible in economics, but they are not probable for the reasons that Alice described.

While I can't say it won't happen as the administration describes it, no corporation would plan their policies on the assumption that everything, absolutely everything, worked out just perfectly. So I don't think the Congress should either.

I think it should use moderate assumptions more similar to the consensus which in turn is similar to the CBO's forecast.

Mr. **Blum**. I would simply add my agreement and point out that I think that while the administration's economic assumptions for the current year aren't really that different from those of many other forecasters, they become increasingly different in the outyears.

I would make two observations. First of all, looking at the blue chip survey, for instance, not a single private forecaster has the combination of events that is in the administration's forecast, which is high growth and low interest rates and low inflation. You may find forecasters that have agreed with one or two of those, but not with all three.

Second, as you look down the road over a 5-year period, that combination of assumptions is just exceedingly optimistic from the point of view of the budget. I think, as Rudy has pointed out, and Dr. Greenspan has pointed out, they are very improbable. I think that is the wrong set of assumptions to be using for budget planning because it gives you the illusion that things are going to work out splendidly without much in the way of policy changes.

Chairman **Rostenkowski**. You know, evidently Bush has assumed the economic growth under the standards of what Ron Reagan's budget has projected, 3.5 percent economic growth. The people that I have talked to are expecting about a 2.5 percent growth of the economy.

We have to make decisions pretty much on what we feel is realistic. That is, as I am afraid, where the honeymoon starts fading and postures start taking different form.

I truly believe that more than any other committee we have tried to be as cooperative as possible in meeting our obligations.

The Budget Committee makes their recommendations and we try to follow in a line.

But it is very difficult for me it accept some of the forecasts of this administration knowing what has happened in the past.

Mr. Rangel will inquire.

Mr. RANGEL. Thank you, Mr. Chairman.

I thank this panel. I will be using most of your testimony in my speeches.

Mr. LEVIN. You are going to give attribution?

Mr. RANGEL. Yes. I am not a presidential candidate, I don't have to do that.

Dr. Penner, you have made a statement here that the rate of improvement from generation-to-generation will be much lower than the United States has been accustomed to in past history. What an impact that has on me. That seems like you have killed the American dream.

It seems like for those who have known poverty, as I told the chairman yesterday, being poor was not nearly as bad when you had hopes and dreams that you could get out of that poverty.

You project a more dismal picture for the generations to follow as a result of the budget deficit and the ratio between the number of aged and the amount of savings we have. I just wonder what economists think when they look at our poor productivity growth compared with that of our tough international competitors. What do they think when they hear we are not going to raise taxes, that we support Gramm-Rudman-Hollings? Do they believe, as I do, that the necessary consequences of this box are a nation with a lack of investment in education, a lack of investment in research and development, a lack of investment in human beings? Taken together won't these trends undercut the caliber of business and labor that we have been so proud of in the past? Do economists ask: where is the leadership that will enable our great country to continue to play a decisive role in world affairs.

Stu Eizenstat testified in front of this committee, and he told us that just due to the drop out rate alone from high school, the lack of quality workers for the labor force costs us $340 billion annually in lost productivity and in foregone taxes. He told us that the prison system in the United States—just supporting that system, the investment, if you will, that we are making—costs us $6 billion every year.

Last, and I don't know what we can do about it, he said that the children being born of teenage parents are costing us $17 billion a year.

It may be just parochial interest, but do economists ever consider this when they evaluate the size of the deficit and where the investments should be made, "Read my lips, no more taxes?" How does an economist fold this into projecting the future economic position that the United States is going to have?

Since, Dr. Penner, you said we should expect less for the next generation, could you comment on that?

Mr. PENNER. Sir, I think I will start plagiarizing your statement for my speeches because you have expressed the problem eloquently. It has been the American dream to believe that each generation will do better by a considerable margin than their parents.

I don't want to say the future generation will be absolutely worse off than us.

It doesn't look like they will be if we have any luck at all. While we are saving very, very little as a nation, we are saving something, and wealth is growing very slowly.

When we compare ourselves to our grandparents and see the extraordinary change that has gone on in that interval, and if we keep up along the current path, our own grandchildren don't have a chance to see the same kind of leap in their living standards.

In assessing that, moreover, you make an extraordinarily good point that while all of us panelists emphasized the importance of cutting the deficit in improving the situation that we have described, it is crucially important how you cut the deficit. As I said in my more complete testimony, referring in this case to defense, it always seems easier somehow to cut the investment components in our spending. That is a result of how we do our budget accounting.

We do it on a cash basis. I am not advocating a capital budget. But in deciding how much to cut the deficit, we should be very sensitive to exactly what we are cutting and whether it is investment or whether it is consumption, or if we are raising taxes, whether those taxes are likely to reduce private consumption or likely to reduce private saving.

I think that is the way most economists think about the whole problem, but it is very complex and hard to explain.

Mr. RANGEL. Dr. Rivlin.

Ms. RIVLIN. "Read my lips" wasn't said by an economist. It was said by a politician.

I agree with the thrust of your statement and that is why I emphasize that we need to save more out of current income in order to increase this productivity and increase the chance that the next generation will be better off than this one. We need two kinds of investment: private investment and public investment. Much of the human investment—improvement in the labor force and education and training—has got to be, in the public sector.

Chairman ROSTENKOWSKI. Mr. Pease will inquire.

Mr. PEASE. Thank you, Mr. Chairman.

I would like to thank our very distinguished chairman for being here today.

Mr. Blum, in your testimony you mentioned blue chip forecasts see a recession during the next 2 years, but that CBO does not.

I would be curious to know what your reasoning is for departing from the blue chip analysts in that respect.

I would also be interested to know if Ms. Rivlin and Mr. Penner agree with you or agree with the blue chip analysts.

Mr. BLUM. I think the critical omen in our forecast and where we depart from many of the private forecasters is the degree of success the Federal Reserve will have in slowing the growth rate of the economy down.

Our forecast hinges critically on the assumption that the Federal Reserve in fact will be able to bring the growth of the economy down slowly and without the kind of hard landing that many other forecasters see.

Ms. RIVLIN. I would subscribe to that, but I think it is risky. The Federal Reserve in the past has occasionally overreacted and turned the economy into recession. It will be harder for the Federal Reserve to have the right policy if the Congress doesn't succeed in getting the deficit down.

Congress and the President together could help by getting the deficit down and not putting so much of a burden on the Federal Reserve.

But like CBO, I believe there is a very good chance that we can have slow growth without recession for the next couple of years, but it is not guaranteed.

Mr. RANGEL [presiding]. Dr. Penner.

Mr. PENNER. As I say in my more complete statement, we are in an era right now where the margin of error is very low for the Federal Reserve. I think they have been behaving most skillfully. I guess I would say it is about 50/50 as to whether we can avoid a recession, say, by the end of fiscal year 1990.

I would also say, however, that the CBO long-term plan has very slow growth. So while they don't attempt to exactly pinpoint the ups and downs of the business cycle in their longer run projections, I think you can have a mild recession and still do as well as the growth path used by CBO.

So the way I would characterize the situation is that if you think we won't have any recession at all for the next 5 years, probably CBO is a little pessimistic. If you think we will have a major recession or if you think we will have two minor recessions, which is quite possible in that kind of time period, then CBO's path would be too optimistic.

Mr. PEASE. Mr. Blum, I have another question about the track record of CBO's forecast for deficits, versus OMB's, since we have talked about that this morning.

In August of 1988, as I recall, OMB predicted a deficit for fiscal year 1989 of about $145.8 billion, just under the $146 billion limit. Do you recall what CBO was estimating at that point?

Mr. BLUM. We were saying the deficit was about $153 billion, but that is because we couldn't count certain asset sales. But we were low for 1989. We are now in agreement with OMB that the deficit for 1989 is likely to be more on the order of $160 billion.

Mr. PEASE. I see.

If I can, I would like to move away from the deficit just to take advantage of the expertise we have at the witness table.

According to today's Post, the President is likely to propose a modified reduction in the capital gains tax to 15 percent. It mentions that tax collections will go up by about $5 billion in fiscal year 1990 as a result.

I would like to know whether each of you believes that in general a capital gains tax cut will increase Federal revenue or decrease Federal revenue. That is an ongoing debate.

Specifically I would like to ask a question in relation to the President's proposal. Isn't it true that if you announced sometime later this year that you will be able to take advantage of a lower capital gains rate it would be a self-fulfilling prophecy? People would hold onto their stocks and realize the gains after this change goes into effect, particularly if they realize in 1991 and 1992 they may have to wait out a 2 or 3 year holding period before selling.

What is your basic attitude toward increased or decreased revenue on capital gains? Isn't the proposal of the President being a little disingenuous in that regard?

Mr. **PENNER**. I am not sure I fully understand the President's proposal from the newspaper account this morning. The way I read it, it seemed to be a proposal that would phase in a capital gains change in a way that the required holding period would become longer and longer as you went on. Therefore the law would become less and less generous.

That would be exactly the kind of proposal that would induce people to act quickly after it was passed, obviously, to take their capital gains, and therefore probably would increase revenues as the thing was being phased in and then obviously reduce them somewhat later.

With regard to a more simple proposal that would just once and for all change the rates, I am biased, but think CBO did a superb study of the revenue implications of capital gains rate changes—I think it was last year. That study admitted that it was extraordinarily difficult to sort things out.

Very obviously there is a positive effect on transactions when you lower the capital gains rate. The point estimate that CBO used indicated that a cut in the rate would lose a little bit of revenue, but the statistics were murky enough that in statistical jargon, if you used the usual kind of confidence interval, it is possible it could raise revenues a little bit.

On the other hand, it is possible it could lose a lot of revenues. You have to keep that in mind, as well. I think it is very uncertain.

However, the positive effect on transactions makes it a cheap investment incentive, even if it loses a little.

Mr. **RANGEL**. Mr. Chandler.

Mr. **PEASE**. I would like to ask Dr. Blum and Dr. Rivlin to comment.

Mr. **RANGEL**. Why don't we let the other people inquire and then, in whatever time is left, we will get a second round. The time has expired.

Mr. Chandler.

Mr. **CHANDLER**. Thank you, Mr. Chairman.

Dr. Rivlin, I especially appreciated your testimony today concerning the Social Security trust funds. I know that a lot of people are suggesting that the answer to this problem is simply to take Social Security off the budget, and adopt a new accounting method. You essentially said it doesn't make any difference how you account for these funds. As long as you are spending them on current operations, the result is very much the same.

If I can follow up on the comments of Mr. Rangel about the American dream, it seems to me that perhaps we have an opportunity here with the Social Security trust funds, to invest them in the true capital investment rather than Treasury bills. Perhaps the money should go into the kinds of things that government does, the infrastructure needs of the Nation—for example, or some of the research needs we have and so forth. But we should truly do it on an investment basis with the expectation that there will be wealth created and therefore a return generated.

Do you see this as a potential solution? Is that the kind of thing we ought to look for? Should we consider investment of some portion of the trust funds just as any other fund manager would do in the market instruments that are available?

What would be your suggestion for improving that situation?

Ms. Rivlin. I would be very reluctant to see the Government buying equities in the private market because then you end up with the Government owning pieces of General Motors and General Electric and so forth. That seems to me undesirable.

You can get the same effect by running a surplus in a unified budget; that is, bringing the rest of the Government's budget closer to balance so that you are actually reducing the debt held by the public. That gets more money out into the private sector where it puts downward pressure on interest rates and stimulates private investment.

Moreover, if you have a strong program of public investment in support of research and infrastructure and trading and those things, then you can justify offsetting the cost of that with part of the Social Security surplus.

What I think you shouldn't do is what we are doing now, that is, use the Social Security surplus to offset the current expenses of Government. Government investment, any way you calculate it, has not been increasing in this period of high Government deficits.

Mr. Chandler. That is such a brilliant answer. I totally agree.

Dr. Penner, you also in your written testimony mentioned Social Security and medicare, but you are talking about the potential for delaying the actual retirement date and then bemoan the fact that even if we did it, as perhaps positive as it would be, we don't really get any credit for that in terms of reduction of liability or reduction of our budget deficit.

Could you talk a little more about that, the idea you have and the potential benefits it would derive.

Mr. Penner. Well, I used it as an example of a problem in current budgeting. That would be one option for reducing the burden of supporting the elderly population in the 21st century, to phase in an increase in the retirement age that is somewhat more rapid than that in current law.

I noted that if you did such a thing, it would be good to do it right away so that people would have enough warning to change their plans.

On the other hand, it is inherent in the congressional budget process that this committee would get no budget reduction credit for that at all, because the way I do it, it would just save money after 2010.

I think it would be far too complicated to try and formally alter the budget process to provide a credit, say, for the present value of that kind of saving. But I do think it is something that should be discussed and debated when you are setting deficit targets, that is to say, if by some magic tomorrow you could pass such a proposal, because it would lower future burdens, it would provide a real good substantive reason for being less ambitious about current budget deficit reduction.

In other words, what I am suggesting is that in an ideal world the choice of the deficit target would depend a great deal on the composition of current spending, as Mr. Rangel pointed out, especially on how much is invested by the Government and how much is consumed, and on the pattern of that spending through time into the 21st century.

But again, I think it is a matter of discussing it and being flexible about budget targets, and I would not try and concoct a set of rules that would formally do that sort of thing.

Mr. CHANDLER. Thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. Moody will inquire.

Mr. MOODY. Thank you, Mr. Chairman.

Thanks to the panel. First I have a comment and then a question.

It seems to me that we talk about the problem of the deficit, and why it is so important to bring it down, that maybe an insurance analogy would be appropriate. What we are trying to do is reduce the worst things that could happen in some odd years if things didn't go well, instead of minimizing the maximum harm that could happen to the economy—a mini-max objective.

We borrow more and more, as consumption in the United States exceeds production—we are talking about public plus private consumption. Therefore we are importing the difference in real goods terms and paying for it by borrowing. The more you leverage yourself as a country, the more you lose your ability to manipulate monetary policy if something does go wrong.

By getting the deficit down, we are buying a better policy of insurance, although there is nothing you can point to, any more than you can point to the idea that buying fire insurance doesn't make your house nicer to live in at the moment, but it minimizes the damage to your house in coming years.

Is that an appropriate analogy?

Ms. RIVLIN. Yes, especially in the short run it is.

I said in my statement that being dependent on foreigners for savings to finance our investment is precarious for just the reasons you have mentioned. It makes it hard to be masters of our own monetary policy, and it could turn around. They could take the money out.

If you are not dependent on other people for savings, oil or whatever, you are just in a better position. Getting the deficit down is part of that insurance.

In the long run, however, I think of deficit reduction more as a way of increasing the chances that our economy will grow faster by having more saving.

Mr. MOODY. Let me talk about savings in real terms as a follow-up question.

It is often said that the Government is using up all of these savings, which indeed it is, to run the Government. Yet much of what the Government is doing on the spending side is not really commanding direct command over real resources, but, rather, transfer payments. Half the budget is practically transfer payments and another 17 percent is interest payments. When we spend money to service a debt, we are not commanding resources; we are simply shuffling paper assets, and private individuals out there get payments and then they go and command resources.

Is it realistic to think the Government is really borrowing, let's say, from the Social Security trust fund to command resources? In fact are we not shuffling those resources back to other private sector persons—just as when people criticize leveraged buyouts for soaking up all that capital, they forget that capital goes back into the economy and doesn't decrease savings in any net sense?

Do you want to react to that question?

Mr. PENNER. Could I comment on your insurance analogy, first of all?

I think what you said is exactly right. There are some major risks out there. It is too bad we have to have them. But there are two parts to it. There are short-term risks like, say, an international financial crisis. Then there is the growth effect that Alice and Jim and I have been talking about. That is not a risk; that is a virtual certainty. We know we are lowering the growth rate in the long run.

There are these two parts to it.

Mr. MOODY. Does real savings really impact it as much as we conventionally think it does, when you consider the fact that much of what the Government spends is really a reshuffling? It is not a command over real resources.

Mr. PENNER. You are absolutely right about that, in that the real cost, the real direct cost to Government, is the purchase of goods and services from the economy. That is most relevant in defense, we are actually using steel and aluminum to build fighter planes, et cetera.

The vast majority of Government activities are these transfer payments, which is, in essence, shuffling money from taxpayers to recipients.

Mr. MOODY. To bond holders.

Mr. PENNER. In some cases, yes.

The important question then is: What is all that shuffling doing to economic behavior; how does it affect the propensity to consume, to save; how does it affect work effort and so on?

Looking at it as an economist, economists always say there are two aspects to the burden of taxation. There is the direct cost of extracting the resources, the buying power out of the economy and from people, and then there is the effect of how taxes distort behavior. We like to refer to that as the excess burden of taxation.

Well, transfer payments are negative taxation. They affect behavior. I suspect the effect of the entire transfer system is indeed to increase consumption a little bit at the expense of saving and to reduce work effort a little bit.

Mr. MOODY. Any other comments?

On the question about real flows, $170 billion is interest payments. Is that really Government spending in the normal sense?

Ms. RIVLIN. Well, on balance, if the Government is putting more money out there than it is taking in, and borrowing the difference, it is putting upward pressure on interest rates. All of those things are real effects.

Mr. BLUM. I think the thing to keep sharply in mind is the fact that when you look at savings for the Nation as a whole, private as well as public, both have fallen remarkably during the 1980's. This is really the problem we are all looking at, that the public sector at least is somewhat responsible for that falling. As a result, we are importing large amounts of foreign capital to keep our investment up.

Those external debts are growing quite rapidly. At this point they are roughly $500 billion. During the next 5 years that will double.

Mr. RANGEL [presiding]. Mr. Sundquist.

Mr. SUNDQUIST. Thank you, Mr. Chairman.

I thank the panel. I have two questions. The first one is a yes or no question.

Given the chance that with a capital gains tax reduction there is a chance we can stimulate investments and perhaps pick up money, or at the worst cost a little money—is capital gains a good idea at this time, given this low risk?

Yes or no, I would ask each of you.

Mr. PENNER. I would not do it.

Ms. RIVLIN. I would do something different.

Mr. SUNDQUIST. Yes or no?

Ms. RIVLIN. No.

Mr. BLUM. CBO doesn't take policy positions. That is a question for you to answer, and not us.

Mr. SUNDQUIST. OK.

Dr. Rivlin, you mentioned in your testimony that as we move into the 1990's we are going to have substantial changes in policy; they are going to be necessary to achieve increase in savings, to improve productivity, to pick up on R&D, to make us more competitive, and reduce foreign investments.

We have been listening to testimony on LBO's and the relationship of debt and equity.

Would you comment on LBO's and the economy in general, on the effect of reducing corporate deductibility of interest, and the double taxation on dividends. What compensation of policy changes would we have to do to get the kinds of things you talked about that we need in the 1990's. What effects will they have and in what direction you would go?

Ms. RIVLIN. To the extent that we are worried that corporations are over-leveraged and that they have too much debt in relation to equity, I think that is a real worry. It is a real worry if we did have a rapid downturn in the economy. Corporations might be in a weaker position than they would otherwise be. Changing the tax treatment to favor equity financing over interest financing might be useful. Obviously you can go one way or the other, get rid of the deductibility of interest or treat dividends in the same way that you treat interest. I am not enough of an expert on the ins and outs of this to give you a very good answer. It is well worth exploring.

But I don't think it has a lot to do with what we have been talking about this morning, which really is the national savings rate. We don't know how that would be affected by any of those things.

Mr. SUNDQUIST. Dr. Penner, would you care to comment?

Mr. PENNER. In an ideal world it would be nice to be able to completely integrate the corporate and personal tax systems so you did not have the double taxation of dividends and could mitigate this problem somewhat. That is very hard to pull off. It is especially hard to pull off in a revenue-neutral way. That is important, given our deficit problem.

I think more modest reforms, such as the one you are discussing, say, to take away some of the deductibility of interest and give some deductibility to dividends, would mitigate the LBO problem, if indeed there is a problem there.

But it is very hard to do in an equitable way compared to the current tax system because you have such enormous differences and experiences out there between different kinds of industry as to their typical debt/equity ratio. For example, a car dealer who borrows to the hilt to finance their inventory could be very hurt, very hurt, by such a proposal. Somebody else who runs a business with virtually no debt could gain an enormous amount of money.

It is very difficult, it seems to me, to design that kind of proposal in a way that won't disrupt things. On the other hand, I am always amazed at the ingenuity of this committee. It solves all sorts of problems that I think are impossible to solve.

Mr. Sundquist. Thank you.

Mr. Rangel. Mr. Coyne.

Mr. Coyne. I yield to Mr. Levin.

Mr. Levin. I will try not to use the full 5 minutes.

Mr. Blum, following up Mr. Pease's study, is there a new question, a new CBO study, on this issue of reduction in the capital gains tax and whether there would be lost revenue or added revenue?

Mr. Blum. Yes, there is, one that follows up from our earlier study that we issued last year. I must point out that the study we did last year, as well as this followup study, focus on the effects of a reduction of the capital gains tax for all realizations, not just for usual business assets, for example. It studies the effects after the reduction is fully phased in, not from a budget view of what happens after the first year or second year.

The reason for the second study was to respond to a critique of our original study. It reaffirms our original findings.

Mr. Levin. That shows that after phasing it in, there would likely by a loss, not a gain?

Mr. Blum. That's right. After it is fully phased in, we see a reduction on the order of $4 to $8 billion a year.

Mr. Levin. Alice, you were mentioning an alternative. Would you fill us in on that.

Ms. Rivlin. If you want to do something about capital gains—and I am not sure you should—the thing to do is index them. The rationale for worrying about the capital gains rate, as opposed to other rates, is that if people hold assets for a long time, and a lot of the gain is inflation. You can fix that directly by indexing capital gains. It wouldn't be that complicated. You just produce a table and tell people how much to take off for the length of time they have held it.

I think that would lose revenue in the long run, probably $4 or $5 million. You might make that up in some other ways, like realization of capital gains at death.

Mr. Levin. Let me just quickly diagram your statement, Rudy, and ask you where you think we should come out in terms of action.

On page 3 and on page 4, I just picked out five phrases. At the bottom, the budget deficit is unlikely to cause an economic crisis.

Then, number 2, that is far from saying it is not harmful.

And then on page 4, our generation is leaving our descendants with much less capacity to improve their standard of living than our predecessors left us.

Then further down, nevertheless with any luck at all future workers should still be better off than current workers.

Then, number 5, it all boils down to the question of what sort of country we wish to leave to our descendants. Fundamentally this is a moral question.

Sitting here, how urgent are you saying the deficit is? I find it difficult, when you take those five statements out of this, those five clauses out of your statement, to quite know how compelling you feel the deficit is in the way of action.

Mr. **Penner.** Well, I do think that it is fundamentally a moral issue. I think that while there is still a small probability that the deficit could directly or indirectly result in some kind of economic crisis, it is a remote possibility at this point. The important question is "What kind of country do we want to leave to our descendants?"

That goes beyond the question of just their material income; it goes to the question of the role of the United States in the world, both militarily and economically.

Speaking not as an economist but as a citizen, I make the moral judgment that we should try to do at least as much for our descendants as our ancestors did for us. That is a kind of Golden Rule—do unto others as you would have them do unto you. That, to me, means doing something rather significant about this budget deficit.

Will the world collapse if you don't? I doubt it. But it just won't look very nice.

Mr. **Levin.** Thank you.

Mr. **Rangel.** Mr. Brown.

Mr. **Brown.** Thank you, Mr. Chairman.

Dr. Rivlin, you noted earlier that the panel today were economists and not politicians. I must say, though, that while you may not be politicians, you are certainly diplomats. You have been able to discuss the deficiencies in the President's economic and budget estimates, without noting that this Congress will adopt those estimates and without noting that those very fanciful estimates—and I agree with your testimony—have been pretty typical of the estimates throughout this decade. As a matter of fact, Congress has adopted every single one of them.

The exercise of criticizing the estimates strikes me as somewhat partisan when it comes to us beating up on those estimates. As a matter of fact, Dr. Penner may remember that the first year I served on the Budget Committee I offered a motion in the committee, after everyone agreed the estimates were wrong, to change the estimates and use either CBO's or the blue chip estimates. That lost on a close vote. Then the Rules Committee refused to even permit an amendment that would adopt more realistic estimates when it came to the floor.

So I must say, I agree with your criticism of the estimates. I think it is unfortunate that bringing real criticism into this process has been so partisan.

I have two questions that I thought might be helpful here.

I am wondering if any of you have put together an estimate of how much Congress's unwillingness to stay within the budget document they adopt has added to the deficits during this decade.

Mr. BLUM. One kind of estimate that we have done at the Congressional Budget Office is to compare the actual outcomes with the deficit targets established in the budget resolutions over the course of——

Mr. BROWN. No, I'm sorry. The question I have is on the spending side, a comparison of outlays, actual outlays, with budget outlays.

Mr. BLUM. That was part of what I was going to respond to.

When we look at the actual outcomes in comparison with the original budget plans adopted, we find on the average that over the 1980's the actual deficit was more than $40 billion higher than the deficit adopted in the budget resolution. Not all of that can be blamed on the Congress directly in the sense that the policy initiatives you planned as part of your budget resolution didn't happen; that is only some of the story.

To a great extent about half of that shortfall is due to using economic assumptions that didn't prove to be accurate.

I think to pick up on your first observation——

Mr. BROWN. I wonder if we could go back. Is it possible that that information can be prepared?

Mr. BLUM. It is. It is prepared.

Mr. BROWN. I think the figures you are giving me include variations in revenue as well as variations in outlays.

Mr. BLUM. If you would turn to appendix A in our annual report on page 105——

What we have here is what happened in fiscal year 1988. A year ago in our annual report we took this analysis back all the way to 1980. What you see here is the results for 1988.

Mr. MOODY. Can you walk us through that table?

Mr. BLUM. Sure.

With respect to 1988, the deficit essentially was $45.6 billion higher than called for in the budget resolution adopted for that year.

Of that higher amount, we could attribute essentially $9 billion to the policy assumptions not working out.

Mr. MOODY. That is 1988?

Mr. BLUM. For 1988 only. The economic assumptions contributed another $8 billion in terms of the assessment, while technical assumptions in this particular year accounted for the bulk of the differences. I think heretofore, it is the economic assumptions that have contributed the bulk of the differences.

Mr. BROWN. Help me with what you are looking at here. You are talking about policy assumptions, technical assumptions and economic assumptions. Obviously, if we set a target outlay amount, and then we spend more than that targeted outlay amount, it may be caused by a variety of factors.

You know State legislators. If they spend more in one area than they plan, they try to either adjust their spending plan in that area or take money from other programs to set priorities.

Maybe if you could help me with understanding what you are saying by policy assumptions and technical assumptions?

Mr. BLUM. By policy assumptions we mean the outlay reductions that may have been contemplated, or specific policy decisions that were embodied in a budget resolution but did not happen, or revenue increases that were contemplated in a budget resolution but did not happen.

In this particular case, the budget resolution in effect assumed that for 1988 taxes would be raised through legislative action to the tune of $21 billion, whereas only $10 billion in higher taxes were enacted as a result of the summit agreement that was reached in November 1987, leaving a shortfall of $11 billion.

Mr. BROWN. The technical assumptions?

Mr. BLUM. Under technical assumptions we are essentially looking at a whole host of factors that drive outlays. They range from how quickly the Defense Department spends out of appropriations to how much deposit insurance activities are going to cost.

I think what happened here in the case of the outlays, is that we had more in the way of cost, for instance, for deposit insurance programs for instance than we were expecting at the time when the budget resolution was put together.

Mr. RANGEL. The gentleman time has expired.

The Chair recognizes Mr. Coyne.

Mr. COYNE. I would address this question to Mr. Blum or any of the panelists that would care to respond.

We are told the national economy is made up of 75 percent service type jobs. I was wondering if this move to the service producing economy has made any difference in the way we project real growth in the gross national product?

Ms. RIVLIN. I wouldn't think so. We have had, as all countries have, a long period of movement of labor from agricultural manufacturing into services. There are some reasons why services are harder to deal with. It is harder to measure productivity in services.

So far as just counting the current product, it doesn't seem to me that it makes it significantly more difficult. It may make it more difficult to project the productivity increase component. Productivity in the services has not been increasing very much. We would like to get it up. Nobody knows exactly how to do it. Certainly if we are making long run projections, that introduces an element of uncertainty.

Mr. COYNE. Anyone else care to comment?

Mr. PENNER. I guess I think it is a little more serious than Alice suggested in that the problem of measuring productivity arise because it is so hard to measure what the price of the service is.

Therefore, it is hard to know what the real growth of production in the service industry is. It is my hunch that we greatly overstate inflation in the service industries that we, therefore, understate the rate of real production growth and productivity growth.

To give you one example, suppose that a grocery store decides to serve their customers better. They put a butcher behind the meat counter to discuss the meat and so on. In our official statistics that would probably just show up as an increase in the price of the meat.

No where would our official statistics count the real improvement in the quality of service that results from having a real live human being behind the counter as opposed to picking the meat off of it yourself.

Mr. COYNE. How does this shift to ~~a service~~ producing economy affect the importance of plant capacity estimates?

Mr. BLUM. I think this has made the capacity estimates more vulnerable to interpretation. It gives them a wider range, or one must take them with a greater degree of salt.

Mr. COYNE. The plant capacity estimates?

Mr. BLUM. That is right. I think there is a great deal of unhappiness over exactly what that series is telling us, how much faith one can put in it. At the same time, I think this is only one of many factors that an economist looks at in reaching a judgment as to whether or not the economy is operating close to full capacity or potential. It is not the only factor.

The rate of unemployment is clearly a very key factor in that regard. Unemployment rates have fallen considerably. I think we are operating close to the full employment level.

Mr. RANGEL. Mrs. Johnson.

Mrs. JOHNSON. Thank you, Mr. Chairman.

I appreciate the panel's thoughtful work over many years. It seems to me that there is something that we are not able to account for.

Since I agree with Dr. Penner that we are in an era where there is ~~not much~~ margin for error, I am concerned with our blindness to what I consider to be one of the things that is happening out there that matters a lot to us.

For example, let's talk about plant capacity and using that to try to evaluate where we are in an era. As I go through the manufacturing facilities in my district, and I spend a lot time there, what I see is doubling in plant productivity and reducing space at the same time. In a sense plant capacity doesn't tell us what it used to tell us.

I very much agree we need to improve skills, training, knowledge and adaptability. But I don't agree it would necessarily require new investment.

Look at the waste in almost every one of our educational facilities at every age level since they are idle most of the summer or at least certain months of the year. Do we need new plants?

We need better use of the people and property that we have. In fact, when I look at what is happening out there in my plants in the manufacturing sector, most of the productivity gain is not from new investment.

As important as I think the deficit is, and I absolutely agree with you on what you say about that and what the implications of it are, I hope to see a part of it in the public sector, where we have moderate control, that we move toward a more rational policy in regard to debt and saving.

But in the private sector we have proved markedly unsuccessful in stimulating savings. But we do see dramatic things happening in terms of productivity. What I am pointing to is the kind of a blindness in our assumptions, an inability in our assumptions to take advantage of that one new area of policy where we could make a significant difference in addressing our problems.

Yet, it is not something we talk about, nor is it something we put pressure on.

We have begun to do this in health care costs and usage of hospital facilities, but we are not doing this in education. Government isn't doing this in terms of quality of services and cost benefits of services in the public sector.

So I think there is sort of a blindness in a certain aspect of our policy and an inability of our statistics to acknowledge that blindness. When I look at the problems you have laid out, I see the solutions not in the traditional areas but in nontraditional areas where public policy has not been a very effective lever.

I ask you as you look at the solutions and the reality as to where the solutions are coming from and where they are going to come from, what changes do we need to make in how we in technical assumptions, economic assumptions, in how we derive them, use them and see them to give us a better ability to predict our needs?

Mr. PENNER. Well, you put your finger on some very difficult problems. I think there are two kinds of blindness, one I would call a conceptual blindness. That is to say economists simply do not understand everything that goes into productivity growth.

Using the usual measures of economics, we cannot fully explain why productivity growth today is so much lower than it was in the 1960's. That will take a lot of research.

Perhaps, some of that research should break out of the traditional boundaries of economics and look at some of the issues that you talk about. That is going to be hard work. It is hard to predict how fast that work will be successful.

The other kind of blindness that you mentioned is statistical blindness. I said more generally earlier that as we cut the budget, it always seems to be easiest to cut investment.

One of the things we really cut in the last number of years are the budgets of our statistical gathering agencies. That wasn't all harmful. In may ways they became more efficient as a result of that. We have gotten rid of some bad data series.

But I think it is hurting at this point and that there are a lot of areas in which improvements could be made, especially in something like the capital utilization measure. That is a terrible statistic. Its quality is really bad.

There is a need, I think, at this point to invest more in trying to improve statistical concepts and put more money into our statistical agencies.

Ms. RIVLIN. Capacity measures have never been terribly helpful. They are a proxy for a lot of other things. We are realizing that more.

When I talk about investment in human capital, I don't just mean building school buildings. If we use the school buildings more intensively and use them in the summer, that would mean paying more teachers. That is a form of investment in itself.

Mrs. JOHNSON. Well, it may or may not require paying more teachers. What are we beginning to look at in terms of our university professors? What about intensity of responsibility and so on?

Ms. RIVLIN. It could mean teachers working harder for the same amount of money. I am not sure there is a lot of potential for that in the public school system.

Mrs. JOHNSON. Thank you.

Mr. RANGEL. Mr. Pease.

Mr. PEASE. Mr. Chairman, thank you very much.

I would like to go back to my original question on capital gains. We have had some discussion of that in the interim. I think all that remains is for me to ask Dr. Rivlin whether she would say that in general capital gains reduction would increase or decrease Federal revenue after an initial phase-in period.

Ms. RIVLIN. I think there is no question, in the long run it would reduce it. If you increase the number of transactions in which people realize gains because they want to do so quickly for tax reasons, you could get more revenue at the beginning. In the end you will get less.

Mr. PEASE. We have heard from Chairman Greenspan a number of times on the question of reducing deficits. Almost invariably he indicates that the reduction in the deficits have to come, in his view, from spending reduction, not from increases in taxes or revenue, almost implying that deficit reduction via tax increases is not really legitimate or doesn't really serve the purpose.

I wonder if each of you could comment on the relative value of spending cuts versus revenue increases in reducing deficits.

Ms. RIVLIN. I think that is a political, not an economic, question.

You could certainly imagine crazy kinds of tax increases that would be very deleterious to the economy. But in the range of things that people actually talk about, small changes in tax rates have very little effect on economic behavior—I think it really is a political and a philosophical question.

If you want the Government to do more, then we have to pay for it. The only other alternative is to have the Government do less.

Mr. PENNER. I think it is a real shame that we have become so religious about what appears on the revenue side and what appears on the outlay side. Very often it is just an arbitrary accounting distinction.

For example, I think one option that might be considered by this committee is to tax a greater portion of Social Security benefits. I don't know if I want to call that an outlay cut or a tax increase. It has to be judged on its own merit.

As a general principle it is hard to design tax increases that do not create some disincentives that have negative economic effects. But even there, there are exceptions. I think reducing the implicit subsidy for the purchase of health insurance as a fringe benefit could increase the efficiency of the economy. Conversely, there are cuts in the spending side that would reduce efficiency, like cuts in investment infrastructure and so on.

So I really hate to generalize and say that something is bad because it affects revenues and something is good because it affects outlays, or vice-versa. I don't think you can generalize. Each individual deficit-cutting option has to be judged on its own merits, whether it is called a tax increase or an outlay cut.

Mr. RANGEL. Mr. Blum.

Mr. BLUM. I would subscribe to Rudy's remarks and add that probably in the aggregate there may not be much difference which side of the ledger you are working on. But it can make some differences in terms of which programs are cut or which taxes are increased, in terms of the efficiency of the economy and in terms of taxpayer behavior.

Certainly, as we have talked this morning, reducing Federal expenditures for what can be termed public investment doesn't help from the longer run point of view of building up national savings and investment. Similarly, if we are working on the tax side, most measures that deal with broadening the tax base would be more efficient from an economic growth point of view than an increased marginal income tax rate, for example.

Again looking at it from the point of view of economic growth, taxes that are focused more on consumption rather than on saving would be beneficial.

Mr. RANGEL. Mr. Pease.

Mr. PEASE. The responses from all three of you have been very helpful to me. I can accept philosophical differences over whether revenue or spending cuts would be the preferred path.

I was interested in whether it made an economic difference. The message I get from the three of you is that essentially it does not.

Mr. RANGEL. Mr. Moody.

Mr. MOODY. If I could ask a followup question, you were asked to make a yes or no answer earlier on the capital gains issue. I would like you to make another yes or no answer.

The President's proposal, if what we read is correct, may have a perverse incentive. It may unlock assets quicker as a result of the tax change, rather than hold them.

Could you contrast that with, let's say, indexing the base to inflation so that the longer you hold, at least there is no tax incentive to not hold things because you are being increasingly taxed with purely inflationary gains? Wouldn't that be a more economically neutral tax regime than some of the sudden effects of having 6-month or 12-month cutoffs?

Ms. RIVLIN. That is one for which I have a yes or no answer—yes.

Mr. MOODY. Do other members of the panel want to comment on the capital gains, on that way to handle the long-term/short-term problem on capital gains?

Mr. PENNER. I think it is a better way to go. I don't think we should kid ourselves into thinking that solves all the problem. That would be indexing one part of the tax system.

Mr. MOODY. What would you do with interest payments?

Mr. PENNER. That is the problem. It gets very, very complicated very fast as you go down that road.

Ms. RIVLIN. Indexing the base is progress even if you don't index interest payments, it seems to me.

Mr. BLUM. In terms of indexing the bases, that would maintain, in essence, the purity of the tax reform measures that you took in 1986.

Mr. PENNER. If I could be a little more philosophical about the issue, I do think that a special capital gains tax is a cheap investment incentive. I do think that tax reform, the magnificent achievement that it was politically, came out a bit heavy on the taxation of capital income.

But right at this moment in time, I think one of the most important needs is for some stability in the tax system. I would really like to keep the basic features of tax reform in place for at least another year.

Mr. MOODY. Including the marginal rates?

Mr. PENNER. Including the marginal rates.

I guess now that I am getting political, but I would predict that if you did do something for capital gains, which is mainly an issue for the very rich, you would raise the top marginal rate at the same time. As soon as you do that, it seems to me the whole magnificent structure begins to unravel.

Mr. MOODY. As you raise the marginal rates at the top, you increase pressure for exemptions?

Mr. PENNER. Exactly. It is complicated to differentiate a capital gain from regular income. However you write the many pages of tax law required to do that, you will end up in a position where a lot of executives will find ways to translate what both of us would probably call regular income into something that legally is called a capital gain.

So I think there are all sorts of problems with going down a special capital gains rate route at this moment.

Mr. RANGEL. Is anyone else seeking recognition?

Before we recess until 2, I would like to ask Dr. Penner a question. Some people would argue that any tax on Social Security based on income violates the legislative intent of the Social Security system.

How do you respond?

Mr. PENNER. Maybe I am missing something, but I don't know how it would. I would, for the purpose of designing the reform, treat Social Security benefits just as we treat private pension income in the tax law. So I would give some credit for payments made out of after-tax income for payroll taxes.

According to current calculations, that amounts to about 15 percent of the benefits, which is an indicator of what a small portion of benefits people have paid for. Therefore that would imply putting about 85 percent of the benefits into the tax base.

Mr. RANGEL. The chairman asked me to thank this panel for the contribution you made today and over the years. We look forward to working with you and depending on your advice as we try to solve these complicated problems.

Thank you very much.

The committee stands adjourned until 2.

[Whereupon, at 11:45 a.m., the committee recessed, to be reconvened at 2 p.m.]

Mr. RANGEL. The Ways and Means Committee will come to order.

The chairman has prepared a statement that indicated that over the past 3 days the committee has listened to recommendations about how to address the problem of the budget deficit. This afternoon we will address the important issue of the relationship between the Social Security and Medicare trust funds and the budget.

We are pleased to welcome experts in this field, Dr. Aaron, Mr. Ball, and Mr. Myers. We look forward to hearing your testimony.

Our colleague Congressman Dorgan requested that the following statement be read into the record where he indicates.

"I regret I will be unable to attend the hearing this afternoon. I have been called home to North Dakota due to the serious illness in my family. Dr. Aaron, Mr. Ball and Mr. Myers are experts on the subject of Social Security and their testimony is very valuable. I have had the good fortune to work closely with these gentlemen during this past year on the subject of the Social Security trust fund. Today I have introduced legislation to take the Social Security trust fund out of the Government's deficit calculations. I look forward to working with the gentlemen on this panel and my colleagues in Congress on this issue."

Is any member seeking recognition before I ask Dr. Aaron to present his testimony?

Well, this is an outstanding panel. Every time we have a problem, we go to the same experts.

Dr. Aaron got out of this one.

All of your statements will be entered into the record without opposition. Meanwhile you may proceed in any manner you feel comfortable.

STATEMENT OF HENRY J. AARON, PH.D., SENIOR FELLOW, THE BROOKINGS INSTITUTION

Mr. AARON. I will highlight a few of the points I cover in my testimony. I focus on three main questions.

The first concerns the overall deficit.

The second main question that I address is predicated on the assumption that we do want to eliminate the deficit. If so, how should we define and measure the deficit?

The final question that I take up concerns what changes in social insurance can be defended as reasonable in light of the long-run objectives of the program that would also make some contribution to deficit reduction.

I can't resist going back to the dire forecast about the the consequences that the deficit would have for the economy which we have been hearing now for a great many years.

Indeed, I have contributed to them on occasion. These forecasts are inherently peculiar, since some people feared inflation, while others were concerned about it causing a recession. If one can justify both concerns, it suggests flaws in ones reasoning.

The sky has not fallen. There is no indication now that the economy is going to be pushed into recession or into inflation because of the deficit.

The real problem is that national savings is too low and the deficit is a contributory element.

The U.S. savings rate after depreciation, which ran 7 to 8 percent of national product from the end of World War II through 1980, has in the last 3 years been running in the vicinity of 2 to 3 percent of national product. At least half of that drop is attributable to the Federal deficit.

My answer to the second question about how we should measure the deficit, rests on this perception that saving is inadequate.

We should measure the deficit in the way that would be most helpful for adding to the national savings rate.

My colleague Charles Schultze at Brookings did some calculations for the first conference the National Academy of Social Insurance in which he suggested that, first that there are no clear indications that the national private savings rate is likely to rise; second, that if all of that saving were available for private investment here or abroad, it would be sufficient to meet investment requirements, to equip the growing labor force, and to take advantage of technological advances.

That rate of private savings, however, makes no allowance for the obligations that we are incurring today to provide benefits in the future to the retired, disabled and survivors through at least four existing Federal programs and that we are very likely to provide through other programs that may be created in the future.

Existing programs are Social Security, Medicare, civil service retirement, military retirement. Additional programs are waiting in the wings to place economic burdens upon the economy. For example, there will very likely be some plan to provide for long-term care either through public or private budgets.

If we were setting aside for additions to the capital stock, the surplus now being accummulated in the four programs, Medicare, Social Security, civil service and military retirement, the table attached to my testimony indicates how the deficit on the rest of the Government operations would appear.

The deficit on the rest of the Government operations in 1988 would have been not $155 billion, but $244 billion. Rather than shrinking to $130 billion by 1994, as the Congressional Budget Office quite reasonably projects for the overall deficit, the deficit on operations of Government other than those four programs is projected to reach $307 billion by 1994.

What I am suggesting then is that the Gramm-Rudman targets which are useful interim targets for reducing the Federal deficit, should be regarded as interim targets and not as the final goal.

In the end, we should be running a sizable surplus within the public sector to help add to national saving, build up the capital stock, and increase our productive capacity in anticipation of the quite predictable cost we are going to incur to provide benefits for the retired, the disabled and for survivors.

It would also help add to the insufficient savings rate the United States is now generating.

Let me wind up, by commenting briefly on a couple of changes in Social Security which I believe, and in Medicare, which I believe deserve serious consideration as part of a deficit reduction package.

Then I would like to comment on one that has enjoyed a good deal of public support that I believe is a candidate for one of the poorest public policy ideas of the year.

The first of the two changes that I think merit consideration for deficit reduction and for changes in the structure of our overall taxation and Social Security and Medicare systems is an increase in the proportion of Social Security benefits subject to tax under the personal income tax. Social Security continues to be treated more favorably under the personal income tax than are private pensions. I can see no basis in tax policy for treating them differently.

Various estimates have been done of the increase in revenues that treating Social Security like private pensions would generate. CBO put the number at close to $20 billion per year, not over 5 years, but per year by 1994.

The second change that I think merits action in the near future are reforms in the manner in which physicians are reimbursed under Medicare, probably along the lines of the relative-value scales developed in the special study by Prof. William Hsiao of Harvard University. I am not endorsing the specifics of that proposal. It is complicated and changes will have to be made.

But reimbursing physicians on the basis of time and skill applied rather than on the basis of arbitrary fees set in the distant past when procedures were experimental could save the Medicare system money and improve health care delivery at the same time.

The proposals that I think deserve to be viewed with skepticism would do away with or reduce the annual adjustments in Social Security benefits.

I want to distinguish between a one-time suspension of cost-of-living adjustments, which may be a good idea or a bad idea, but should be called by its true name, which is a reduction in benefits.

It is a permanent reduction in benefits by whatever percentage of the increase in the cost of living benefits are not raised by. That may be a good idea, it may be a bad idea.

I think we would have to address the question of whether current benefit levels are too high or too low, and the issue should be resolved on that basis.

Proposals regularly to adjust benefits for only part of the increases in the cost-of-living, in my judgment, make almost no sense whatsoever. Let me give you some illustrations of why I say this.

Limiting cost-of-living increases to, say, 60 percent of the rise in the Consumer Price Index, as suggested by Peter Peterson, or to 2 percent less than the rise in prices, as suggeted, for example, by former Presidents Carter and Ford, amounts to assuring the disabled and elderly steadily less adequate benefits.

The two proposals that are equivalent if the rate of inflation is 5 percent. They would mean that a 25-year old disabled worker would find his benefit reduced by one third by the time he or she reaches age 45, and half by the time he or she reaches 60. A 90-year old retiree who would find his or her benefit worth only 67 percent as much as it was on retirement.

The rationale for the Peterson proposal is particularly hard to comprehend if one fears that inflation will exceed 5 percent.

If, for example, prices rose 10 percent per year, real benefits would be cut 4 percent per year.

That would mean that 25-year old disabled worker would find his benefits slashed 67 percent by the time he reached age 60. The most charitable thing I can say about those proposals is that those who have advanced them have not thought through their implications.

I think it is also important to keep in mind that changes in Social Security which make programmatic sense by definition are not likely to make a major contribution to short-run deficit reduction.

I stress short-run deficit-reduction objectives of the Congress. Major changes in Social Security almost inevitably have to be phased in gradually for reasons of compassion and because of the difficulty that elderly or older workers have in adjusting to changes in benefits.

The unfortunate experience with President Reagan's proposal in 1981 drastically to cut early retirement benefits starting 7 months after the proposal, and Congress' summary reduction of those proposals is one example.

The decision by this committee to defer the a gradual increase in the age at which full benefits could be claimed under Social Security for about two decades is another example of Congress' measured approach to major changes in benefits.

In contrast, increases in the taxation of benefits and changes in the methods by which physicians are reimbursed by Medicare, deserve serious consideration both on programmatic grounds independently from deficit, and because they will lower the deficit from the deficit issue.

Thank you very much.

[The statement of Mr. Aaron follows:]

Statement of Henry Aaron*

before
The Committee on Ways and Means
U. S. House of Representatives

February 9, 1989

Mr. Chairman, thank you for inviting me to testify on the relationship between the current budget deficit and the financing of social security. Social security and medicare in 1989 are projected to account for 29 percent of federal expenditures and 37 percent of federal revenues. Furthermore, a good deal of confusion surrounds the interaction of these programs and the budget in both the short and long runs.

I shall organize my remarks around three main questions. First, why should we care about the overall deficit? Second, on the assumption that we aim to eliminate 'the' deficit or reduce it to some target level, should 'the' deficit include or exclude the social insurance accounts? Third, what changes in social insurance that can be defended as reasonable in light of the long-run objectives of the programs will also make some contribution to the goal of reducing the current budget deficit?

Why is Eliminating the Deficit Important?

For several years, countless experts have been warning that the budget deficit made inflation or recession inevitable. The fact that the deficit was viewed simultaneously as likely to cause inflation, a problem of excessive demand, and recession, a problem of insufficient demand should have alerted listeners to the fuzzy thinking behind these warnings.

In fact, of course, no recession has occurred since 1983, and few forecasters expect one soon. The monetary authorities have managed to regulate the flow of credit so that,given the deficit, total demand led to steady, if unspectacular, economic recovery. Although foreign or domestic economic surprises or mistakes in regulating demand could cause a recession or inflation, neither is inevitable.

While the deficit will not bring rapid death to the current economic expansion, it is a slow poison that threatens long-run economic growth and living standards. It exercises this debilitating effect by diverting about half of private saving from productive investments into public consumption.

The statistics are by now familiar. In 1988, net saving of the private sector and of state and local governments equalled 6.4 percent of net national product. The federal deficit absorbed exactly half of that saving, leaving net national saving of only 3.2 percent of output, about 5 percentage points below the average rate from 1950 through 1980. The shortfall of saving means that the capital stock each year falls progressively farther behind the levels we would have achieved had we maintained our national saving rate. At the end of a decade national income will be reduced about 2 percent if the shortage of saving has no effect on the increase of total productivity, more if technical advance is slowed. It also means that to sustain domestic investment, the United States must borrow abroad, falling progressively farther into international debt. The damage in any one year from low saving will never be stark. But as with most bad habits, the damage accumulates.

How Should We Reckon the Deficit?

The gist of my answer to the question of how we should set budget deficit targets is that we should choose a measure of the deficit because we think it is more likely than others to lead to desired levels of national saving. Members of Congress should recognize that there is no single right way to measure the government's budget deficit or surplus. Numerous economists and accountants have pointed out conceptual flaws and inconsistencies in the way we handle various budget transactions. Some of these flaws can be corrected simply, but correction of others would require complex and arbitrary adjustments that would render our budget accounts incomprehensible to almost everyone.

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Some nations, such as Japan and Italy, in which private saving rates are very high, persistently run government budget deficits far larger than our own and suffer few or no ill effects. Their national saving rates--the difference between private saving and government dissaving--are sufficient to sustain rapid expansion of their capital stocks and contribute to economic growth. The budget deficit is an economic problem for the United States because our already low private saving rate is further depleted by government borrowing.

My colleague Charles Schultze has recently presented estimates that U.S. private saving is unlikely materially to increase in the near future. Nevertheless, it is likely to be sufficient to finance the additions to our capital stock that will be required to equip a growing labor force and accommodate new technology and to finance deficits averaging no more than 1 percent of gross national product, without necessitating net foreign borrowing. This line of argument implies that if the federal government aims for a balanced budget and falls short on the average by about 1 percent of gross national product, as it did during the post World War II years through 1980, the United States will not need to borrow abroad to finance investment.

This amount of saving makes no allowance, however, for the public obligations that are being incurred to provide pension and health benefits to future generations of retired, disabled, and survivor beneficiaries. These obligations will require future cohorts of workers to transfer increased amounts of current production to inactive members of the population. If social security and medicare were privately managed, federal law and regulations would require the creation of reserves to help fund these future obligations. The accumulation of such reserves would add to private and national saving. I know of no one who would argue that the accumulation of such reserves would justify increased federal government deficits. Rather, everyone would recognize that an increase in saving is necessary to assure that private economic agents amass sufficient assets to help defray predictable future costs.

This line of argument indicates that budget deficit reduction targets should be set for activities of government excluding trust fund commitments to provide pensions and health benefits. Accumulations of reserves under pension and health programs should therefore add to national saving, not be used to finance deficits on other operations of government.

With these principals in mind, the deficit in 1988 would have been reckoned at $244 billion, not $155 billion; and the projected deficit for 1994 would be not $130 billion, but $305 billion (see table). In concrete terms, I am suggesting that the Gramm-Rudman-Hollings targets are not good enough. Reaching these targets implies using all additions to reserves under social security, medicare, and civilian and military retirement programs to pay for deficits elsewhere in the federal budget. Using the reserves to pay for deficits elsewhere in government undermines the economic benefits of building reserves up, because doing so prevents the reserves from adding to saving, increasing the capital stock, and boosting the productive capacity of the country when the IOUs to potential beneficiaries come due.

In fact, the task is even larger than the numbers in the table indicate. The additions to medicare hospital insurance reserves shown in the table are insufficient, together with scheduled payroll taxes, to pay for promised benefits. Based on current cost projections and calculations contained in a recent Brookings book (Can America Afford To Grow Old, Brookings 1988), an immediate increase in the payroll tax rate by roughly 1 percentage point would fund hospital insurance adequately for the next twenty-five years. The tax increase may be delayed, of course, but a delayed tax will have to be bigger. Additional increases in payroll taxes will be necessary in the future to maintain actuarial balance.

And there is more. The totals shown in the table make no allowance for the promised benefits under part B of medicare. We are at present doing nothing to build up reserves to meet these predictable costs.

I wish to reiterate that the failure to convert the budget deficit into a budget surplus need not cause inflation or recession. Nor will it prevent the United States economy from enjoying some economic growth as science advances. What it will do with the reliability of an atomic clock is curtail the increase of the U.S. capital stock and retard economic growth. It will necessitate either drastic cuts in investment or continued and massive reliance on borrowing from abroad. Furthermore, failure to assure that accumulations of reserves in the social security and medicare systems result in increased saving will saddle future workers with the costs of benefits that current workers and voters are promising themselves.

What Changes in Social Insurance Can Contribute to Deficit Reduction?

Given the difficulty of meeting even the Gramm-Rudman-Hollings targets, you are unlikely to greet warmly the suggestion that the real task is more than twice as large. Modern messengers who carry unwelcome tidings are treated with more compassion than in the distant past. Instead of being executed, they are merely ignored. I want to conclude, therefore, with references to some changes in social insurance policy that would contribute to deficit reduction.

Social insurance programs represent long-term commitments to workers who use them in making long-term decisions about work and retirement. For that reason, Congress has never countenanced large abrupt reductions in benefits. Such changes would falsify expectations on which workers have made plans that are difficult or impossible to change. The utter dismissal of President Reagan's 1981 proposal to cut disability benefits drastically with just a few months notice is the prime example. The Congressional insistence on delaying for two decades the implementation of increases in the age at which full social security benefits can be claimed--the increase in the so-called "retirement age--is another.

This need for caution makes social security and medicare poor tools for meeting short-term deficit reduction goals. But it heighten's the importance of careful examination of promised benefits.

Two changes in social insurance are now under discussion that would improve program structure and contribute to deficit reduction. The inclusion in personal income subject to tax of roughly 85 percent of social security pension benefits would bring the treatment of these pensions into line with that of private pensions. The inclusion of the subsidy value of medicare benefits would also be justified as part of a larger program to extend the personal income tax to include currently untaxed in-kind fringe benefits. In combination, these changes could increase income tax revenues by more than $20 billion in 1994.

Implementation of relative value scales as the basis for physician reimbursement under medicare could be used as the occasion to reduce total physician reimbursement.

Others have proposed curtailing cost-of-living increases in social security benefits. A one-time denial of cost of living adjustments is nothing else than a cut in benefits and can be justified if social security benefits are shown to be too high. Those who believe they are should explain why benefits, which in June 1988 averaged $521 per month for new retiree awards, $475 for new disability awards, and $342 for new awards for widows and widowers are excessive. If such a case can be made, benefits should be cut. But it is disingenuous to cast such benefit cuts as simply reducing the increase beneficiaries would otherwise have received.

Proposals regularly to adjust benefits for only part of increases in the cost of living, in contrast, make almost no sense whatsoever. Some simple examples illustrate why. Limiting cost of living increases to 60 percent of the rise in the consumer price index, as suggested for example by Peter Peterson, or to increase benefits 2 percent less than the rise in prices, as suggested for example by former presidents Carter and Ford, amount to assuring the elderly and disabled steadily diminishing benefits the longer they remain on the benefit rolls. The two proposals, which are equivalent if the inflation rate is 5 percent, would mean that a 25-year old disabled worker would find his benefit reduced one-third by the time he or she reaches age 45 and half by age 60. A 90 year old who retired at age 62 would find his or her benefit worth only 57 percent as much as it was on retirement.

The rationale for the Peterson proposal is particularly hard to comprehend when inflation exceeds 5 percent. If prices rose 10 percent per year, for example, real benefits would be cut 4 percent per year. The purchasing power of the benefit of the 25-year-old disabled worker would be slashed 76 percent by the time he reached age 60. The most charitable thing one can say of those who advance such a proposal is that they have not thought through its implications.

While no one should expect that acceptable changes will make much contribution to reducing the budget deficit in the short run, they can have major implications for long run costs. For example, the linkage of entitlement to medicare benefits with the age of eligibility for unreduced social security benefits would be an important element of encouraging U.S. workers to retire at a later age than is now customary and would significantly reduce the long-term cost of medicare.

In summary:

- The deficit is important and should be eliminated. Allowing the deficit to continue will not make inflation or recession inevitable, but it will keep U.S. saving rates low, with gradually corrosive effects on the capacity of the U.S. economy to grow.

- The proper goal for deficit reduction is far more ambitious than that contained in the Gramm-Rudman-Hollings targets, although the schedule laid out in those targets is reasonable for the next several years. Even if the Gramm-Rudman-Hollings targets are reached, however, the deficit reduction job should not be over.

- Social insurance programs are not part of the short run deficit problem. Payroll taxes for these programs have been raised and benefits have been cut repeatedly in recent years; as a result, these programs are currently running large surpluses. Increasing the fraction of benefits subject to tax can contribute to reducing the deficit in the next few years. Because social security is adequately financed, according to official estimates, other changes in that system should be evaluated on their merits. Acceptable changes, other than increased taxation of benefits, are unlikely to contribute significantly to deficit reduction within a reasonable period of time.

Table 1

Year	1988	1989	1990	1991	1992	1993	1994
CBO baseline deficit	-155	-159	-146	146	140	135	130
Trust Funds for pensions and health benefits	89	111	125	136	149	161	177
Baseline deficit (excluding trustfund surplus for pensions and health benefits[a]	-244	-270	-271	-282	-289	-296	-307

Source: Congressional Budget Office, *Summary of CBO's Analysis of President Reagan's Budgetary Proposals for Fiscal Year 1990*, February 1, 1989 and unpublished tables.

[a] Includes social security, medicare, military retirement, and civilian retirement.

Mr. **Rangel**. Mr. Ball, former Commissioner of Social Security.

STATEMENT OF ROBERT M. BALL, FORMER COMMISSIONER OF SOCIAL SECURITY

Mr. **Ball**. Mr. Chairman, I have an exceptionally long statement. I don't intend to read any of it. If I could hit what I consider to be the high points?

Mr. **Rangel**. Without objection your full statement will be entered into the record.

Mr. **Ball**. Mr. Chairman, without too much rationale and with a desire to avoid any repetition with Mr. Aaron, let me go right to the points that seem to me to involve policy decisions.

My first point is that if we are to have these large buildups in the trust fund—and I say "if" because I will come to an alternative possibility in a minute—but if we are, it seems to me of great importance that we should avoid using the annual surpluses as a substitute for general revenue taxes. We should avoid spending the Social Security annual surplus on the operating expenses and that part of general government that goes into investment.

So partly to promote that view, it would seem to me at some point desirable to remove Social Security from the definition of the budget balance.

I would not be in a hurry to do that, however, I think it is going to be difficult enough to meet the Gramm-Rudman targets counting the Social Security annual surpluses. My suggestion would be that you play out Gramm-Rudman with present accounting arrangements, but then in the same way that Mr. Aaron suggested, at the end, in 1993 if the goal has been reached, then set new deficit reduction targets for the non-Social Security budget, producing thereby Social Security surpluses that are true savings and that would contribute to making it easier to support the retirees of the future.

Although as that suggests, I see some advantage in partial reserve financing for Social Security, I want to stress that I by no means think it is essential. Social Security will work either as a pay-as-you-go or as a partially funded system.

The issue of whether to fund Social Security is more related to non-Social Security issues. It is mostly a value question about the extent to which the present generation of workers should sacrifice for future generations.

As far as Social Security is concerned, we can do it either way. However, if we do chose a fund build up, we need to make it real.

There is really no basis for having a big fund build up in Social Security and just substituting it for general revenue financing of the operations of the Government. That would merely be to adopt a more regressive form of taxation for carrying out general government functions.

On the other hand, as I started to suggest, it seems to me that from a Social Security standpoint, it is desirable not to get locked into the idea that for Social Security purposes you have to have this big fund build up.

An illustration of why that gives me concern involves the situation in the Medicare program as compared with the OASDI program. We have, as you have heard over and over again, very large reserves building in OASDI. At the same time a prediction in the hospital insurance part of Social Security that the fund runs out of money in the very early part of the next century. I am not recommending this, but it is not inconceivable to me that the Congress in the mid-1990's might decide to move some part of the contribution rate for OASDI over to Medicare instead of raising the total contribution rate. That would move OASDI back toward a pay-as-you-go system as against a partial reserve system.

Well, I think it is important to leave that kind of flexibility and not have the situation if you decided to do that not have the country feel that, once again, the financing of OASDI has been undermined. It works perfectly all right as a pay-as-you-go system, and a move in that direction should not be a cause for alarm.

You have to pay somewhat higher contributions later on to make up for interest that is lost. There will be a somewhat smaller pool of goods of services in the future, a loss attributable to the lack of savings from an OASDI fund. But it works.

We have been, in practice on a pay-as-you-go basis in Social Security more or less from the beginning. The history is like this:

Up until 1972 we operated on a theory of partial reserve financing, but we never charged the rates to bring it about. We always had in the law contribution rates which if they had been allowed to go into effect would have built up a sizable reserve. But every time we got near the time when those rates would have built big reserves, they were postponed. In practice it was pay-as-you-go.

In 1972, on the recommendation of the 1971 advisory council, a pay-as-you-go approach was frankly adopted. But at the same time, in order to maintain the traditional balancing of the actuarial estimates over a 75-year period, the Congress put in a rate increase for the year 2011. It was expected that as 2011 approached, a pay-as-you-go schedule would be substituted. The Congress didn't want to scatter small increases through the years following 2011, so instead it used what I came to think of as a "balancing rate" in 2011.

A key thing happened in 1977. The system was underfinanced. And to partly meet the financing problem, that 2011 rate was moved up to 1990, even though it was recognized that the current cost of the system in the 1990's would be relatively low. This raised the possibility of a partial earnings reserve in the relatively near term.

In 1983, on the recommendation of the National Commission on Social Security Reform, that 1990 rate was maintained. It was not increased, but most of it was moved up to 1988. Allowing that 1988 rate to go into effect created what we are now experiencing—the development of a large earnings reserve.

I do not think it is correct to attribute that to a deliberate decision based on the comparison of the merits of pay-as-you-go versus partially reserved financing. The decisions were taken for other reasons.

They were taken because given the shortfalls of 1977, and 1983 it was important to build back an adequate contingency reserve. It was convenient also for the Gramm-Rudman targets to have that rate go into effect. It was certainly important in building back confidence in the system.

But if it was a deliberate policy decision by the National Commission on Social Security Reform, based on the long-term merits of pay-as-you go versus reserve financing, that decision must have been taken when I was out of the room.

Financing just did not get considered in that particular light. I still, however, personally favor taking advantage of what has happened and building such a reserve, with the proviso of continually recognizing that it is not necessary to Social Security. And if later on you should decide to move back toward pay-as-you-go because of the need to shift some of the rate over to Medicare, I would not consider that to be undermining the financing of the OASDI program.

The other point I wanted to make about the buildup of these reserves, if we continue on the present course—I do not think we have it designed in a very sensible way. What we have is a very large buildup culminating about 2030 and then a dissipation of the reserve, ending with a zero reserve some time toward the end of the 75-year period over which the estimates are made.

That might make sense if the problem we were confronted with was the retirement of the baby boom generation which had a peak cost and which was then followed by a lower cost. Under those circumstances you would be saving for that one-time situation and then coming down.

That is not the case, however. The baby boom generation is the leading edge of a new plateau of cost. On the assumption of continuing mortality improvements and on the assumption of continuing low fertility rates, which is the best guess, the cost continues at roughly the plateau reached at the time of the baby boom generation.

If we are going to build these reserves, it seems to me there is a very good case for maintaining them, as you would in a private pension fund and not cashing in the bonds, but keeping the funds and using the interest for part of the financing of the program.

If you added about a 1 percentage point increase on employers and a similar amount to employees at around 2030, the result would be a further build-up in the fund in nominal terms, but a decline in terms of the ratio to benefit outgo in the following year. Coincidentally, you end the 75-year period at about what you would want for a continuing pay-as-you go contingency reserve, one equal to about one or one and a half times the next year's outgo. You get the advantage of a couple of generations of savings out of that approach, and you avoid whatever problem you may think there is in raising the funds after 2030 to redeem the bonds held by Social Security. Instead of that you substitute a tax rate that continues the funds more or less as they are.

To shift Mr. Chairman, to the other point that you wished us to react to, "What can Social Security changes contribute to the short-term budget deficit that makes any kind of sense?"

I am quite reluctant to address this point because I don't believe Social Security belongs in a short-term budget deficit discussion. It is a long-term program. People are paying now for benefits that they may not get for 40, 45 or 50 years. For Social Security to continually come up in talks about a short-term budget changes undermines confidence in the program.

I do not really think it is proper. My belief is that it ought to be hands off on Social Security for deficit reduction unless there are Social Security changes that make sense from a Social Security standpoint that coincidentally contribute to a deficit reduction.

One change that would fit that definition would be to make coverage of Social Security universal. There is only one major group still left out of the Social Security program—the 30 percent of State and local employees who have not come in under the voluntary provision, about 4 million people.

If coverage were extended to them for Medicare, only the new hires are covered now—there would be an increase in Medicare income of about $9 billion over the next 5 years, according to CBO. Of course, under the definitions of Gramm-Rudman it would have the same effect on the deficit.

If you followed the policy that has been applied to Federal employees for the OASDI part of the program, which seems to me a good policy—that is covering the new hires for OASDI—you get an additional $8 billion over 5 years into the OASDI program and for Gramm-Rudman.

That is a good Social Security policy change that helps with deficit reduction. Not to cover this group under Medicare is really unfair to everybody else. Most of those 4 million State and local employees will get Medicare coverage either because of performing the minimum amount of work that is necessary for Medicare coverage when they are not working for State and local government—either before or after State and local employment or moonlighting—or as dependents of someone who is covered. Yet, they will have not paid their fair share toward Medicare because they are not contributing during their careers as State and local employees.

I also support what Mr. Aaron said about the taxation of more Social Security benefits with this caveat; I was more enthusiastic about this proposal before the Catastrophic Health Insurance Act was passed because the increased tax on Social Security benefits would affect the same people as the income related premiums for the catastrophic plan.

I don't know how soon and how often you can come back with tax increases for the same group. I also am not as enthusiastic as he appears to be about doing away completely with the thresholds. Although I agree that would be best in theory and would treat Social Security similarly to contributory private pensions or career Government pensions, I have some doubts.

I support the theory, but, I am concerned about the distributional aspects if you applied the policies without any thresholds at all. It is the right policy, but maybe we should go a little slow in the application of the right policy.

One other thought that I offer with great trepidation: You could save something, maybe in the neighborhood of $5 to $10 billion over the next 5 years if you backed off somewhat from the retirement test changes in the law that have not yet taken effect. These are liberalizations that were in the 1983 legislation on the recommendation of the commission that I was a part of, and I did support the changes within the commission. That is one reason I raise this with some trepidation. Under present law, as you know, above an exempt amount, $1 is deducted from benefits for each $2 earned up to age 70. Next year that becomes $1 for each $3. If you leave it at 1 for 2, there is a savings of about $1 billion a year to the program and of course also to Gramm-Rudman.

A longer term change which doesn't have much immediate impact would be to not go ahead with the actuarial equivalent increment for earnings between 65 and 70. The result of this change in the law, once applied, will mean an increase in benefits for people who work to age 70 of about 25 percent over what was true under the old law.

This increase goes to a group that is by and large relatively well off. I think the rationale for such as increase is somewhat weak. It is an equity argument entirely. I can make a counter argument from an insurance standpoint that it isn't really necessary to give that full actuarial equivalent. Those who continue to work are the lucky ones and have not suffered a loss of income from retirement, and there is no insurance reason to give them an actuarilly equivalent increment

Although this is a long run saving, it is one area that one might want to at least think about.

Finally, in the Medicare program my impression is that there is not very much that is sensible that could be done about further reducing reimbursement to hospitals. The effect of such reduction is likely to be largely a transfer of cost to other payers rather than a true reduction in cost. It would be a transfer largely to private insurance and of course, the workers covered by private insurance. I believe Medicare ought to pay its own way.

I agree with Mr. Aaron's idea that, over time, if we move to a fee schedule—and probably that means one based on a relative value scale—it could result in cost reduction. It isn't necessarily so, however. You have to also control for volume so that physicians don't just perform more procedures at a lower rate. I believe a fee schedule would be helpful.

There are lots of changes over the long term that have a chance of reducing Medicare and total helath costs from research into the causes of disease to prevention of illness from changes in the way people live. After one has said all of those things, and they are worth doing, very much worth doing, we still believe, will have to face up to the fact that the aging of the population and the invention of improved medical procedures will mean more expensive health care even after we have allowed for all the reductions that should be made in terms of preventing unnecessary care.

I think sooner or later—hopefully sooner rather than later—we will have to face up to a true deficit in the financing of the Medicare program and additional expenditures if we do what I think we should do and provide protection for people who are not now protected under health insurance at all.

Thank you.

[The statement of Mr. Ball follows:]

Statement of Robert M. Ball

Mr. Chairman and members of the Committee: My name is Robert Ball. I was Commissioner of Social Security from 1962 to 1973. Prior to my appointment by President Kennedy I was a civil service employee of the Social Security Administration for some twenty years. Since leaving the government in 1973, I have continued to write and speak about Social Security and related programs. I was a member of the 1978-79 Advisory Council on Social Security and more recently was a member of the National Commission on Social Security Reform, the Greenspan Commission, whose recommendations were included in the 1983 Amendments. I am testifying today as an individual and the views expressed are not necessarily those of any organization with which I am associated.

I have been asked to address primarily two questions: my views on the build-up in the Social Security trust funds and the contributions, if any, that program changes in Social Security and Medicare should make to deficit reduction.

THE TRUST FUND BUILD-UP

As is well known, income to old-age, survivors, and disability insurance (OASDI) is now running well ahead of outgo, and under present law trust fund reserves are expected to build to very high levels over the next thirty to forty years. Under the 1988 middle-range II-B projections of the Board of Trustees, about 2030 the funds reach $12 trillion (over $2 trillion in today's dollars). The build-up results partly from the level of the contribution rate established for 1990 and beyond by the 1977 legislation (6.2 percent of earnings), all but 0.14 percent of which was made effective in 1988 by the 1983 legislation, and partly from the benefit reductions and other changes legislated in 1983.

Although OASDI benefit payments have been rising in absolute terms, measured as a percent of the covered payrolls on which program financing is largely based the cost of the program has been declining. According to the II-B projections, the relative costs will remain at levels below those of the recent past until well into the next century. The cost of OASDI benefits in 1988, for example, amounted to 10.73 percent of payrolls, compared to 11.94 percent in 1982--a decline of 10 percent in six years. The cost is projected to decline to 10.30 percent by the year 2000 before climbing moderately to 10.67 percent in the year 2010, and then continuing to climb to 11.86 percent (roughly the 1982 level) in 2015.

Throughout this period and somewhat beyond, the combined contribution rate--12.40 percent of covered payrolls--will be producing income much greater than the cost of benefits. Moreover, the annual surpluses will be even larger than shown by a comparison of costs and contribution rates since the income derived from partially taxing the benefits of higher-income beneficiaries is returned to the trust funds, and interest is earned on the reserves as they build.

Under present law, the II-B projections show it will be necessary in order to pay full benefits to start cashing in trust fund bonds about 2030. This source of financing added to contribution income, the taxation of benefits of upper-income beneficiaries and interest earnings will fully finance the program for approximately 20 years more. (It is certainly not wise to view the long-range projections as exact predictions of future performance, and for this reason the trustees consider the program to be in close actuarial balance over the whole 75 years for which the estimates are made even though the year-by-year estimates show the trust funds to be exhausted about 60 years from now.) It is thus entirely correct to say that the OASDI program is in good financial shape, with costs that should be manageable not only in the near term but for a very long time before it may become necessary to raise the contribution rate above the 6.2 percent rate scheduled for next year.

The cost of hospital insurance (HI), on the other hand, has been rising both in absolute and relative terms. It reached 2.53 percent of covered payrolls in 1987 and the II-B projections show costs reaching 3.42 percent in the year 2000 and 3.96 percent in 2010. That is substantially higher than the combined employer-employee contribution rate of 2.90 percent, the rate now being charged and the maximum scheduled under present law. In their 1988 report, the Social Security trustees estimated that HI reserves, including interest earnings, will continue to build only until 1997 and will then decline, with the system requiring additional financing early in the next century. Exactly how much and how soon will depend on a number of variables, including the impact of research on the diseases associated with aging, other disease-prevention measures, the impact of new medical procedures on costs and the effectiveness of cost-containment efforts. But there can be little doubt that the HI program will require additional funding. According to the trustees, 25 years from now, assuming present trends and no major breakthroughs in cost-reducing research, the employee and employer contribution rate needed to sustain the program could be as much as 2.2 percent of earnings each, compared to the current 1.45 percent, with further increases necessary later.

Medicare Part B, covering mainly physicians' charges, is technically not under-financed (since three-fourths of the cost is funded through general revenues and more of those revenues, it is assumed, will be directed to the program as costs rise), but it is increasingly burdensome, both to taxpayers generally and to those covered by the program who must pay more and more in premiums to help cover program costs. The Medicare program now also includes catastrophic protection, which is intended to be fully financed by an increased premium paid by elderly and disabled beneficiaries and, beginning in 1990, by a supplementary income-related premium to be paid by about 40 percent of those beneficiaries.

Last month the General Accounting Office issued a report to the Chairman of the Subcommittee on Social Security and Family Policy of the Senate Finance Committee entitled, "Social Security, the Trust Fund Reserve Accumulation, the Economy, and the Federal Budget." It includes an exceptionally clear and concise description of the way the reserves interact with the budget and the economy. I recommend the report to the members of the Committee. In light of this report, prepared in the Human Resources Division headed by Assistant Comptroller General Lawrence H. Thompson, it seems to me entirely unnecessary in this testimony to describe the reserve mechanism and its effects. I intend, therefore, to proceed directly to the policy issues raised by the trust fund reserve accumulation and to present in the course of my testimony some historical perspectives on the issues.

There are differences of opinion about whether we should accumulate large Social Security reserves as provided by present law, but I believe there is widespread agreement that if we do, they should not be used simply as a substitute for general taxes and used to pay for the current expenses of general government. Most would argue that any sizable build-up in reserves is justified only if it increases the national savings rate and by enlarging the pool of goods and services makes it easier to support future retirees.

This result would be more likely if Social Security were removed from the determination of deficit targets. If Social Security is accounted for separately and the rest of the budget is brought into approximate balance, the Social Security reserves would represent an increase in national savings and future production and could be so identified. Although the same savings result could be obtained, regardless of how Social Security is accounted for, by running a surplus in a unified budget including all government accounts, the identification of Social Security as the source of government savings provides an easily understood rationale for a policy of federal surpluses.

One result of such a policy would be that the Social Security trust funds would gradually buy up the existing debt of the United States. Under present arrangements, beginning about 2030, the Treasury would need to raise money to redeem the debt instruments held by Social Security so that full benefits could be paid. The Treasury would not, however, at the same time, have to service a privately-held debt, as it would if the Social Security reserves had been used to pay the current expenses of the general government rather than to buy outstanding debt. If we continue as we are, the total debt of the United States--Social Security held debt plus privately held debt--will be larger and more difficult to finance.

There are some advantages to Social Security as an institution in having such a reserve and protecting it. The claims of future beneficiaries would be somewhat more solidly based since they would have paid more of their own way than if the system were on a pay-as-you-go basis. It would also be at least marginally easier for future workers to pay Social Security contributions because they would have a somewhat higher standard of living than they would in the absence of the higher saving rate attributable to the Social Security build-up. Moreover, the trust fund build-up is certainly helping to increase public confidence in the ability of the system to pay future benefits. The real gain, however, has little to do with Social Security. The real gain is the somewhat larger pool of goods and services available in the future. On the other side of the argument, it is important to remember that this increase from Social Security induced savings is an addition to a higher standard of living to be expected in the future in any event, and that the gain from this increased savings results from the sacrifice of those working today. Savings help in the future and reduce consumption now.

Although I favor removing Social Security from the deficit targets, I would not be in a hurry. It seems to me that the task of meeting the Gramm/Rudman/Hollings (GRH) targets with the Social Security surpluses included is difficult enough and that we should proceed with the present accounting arrangements until those targets are reached. To do otherwise, I believe, would put too much pressure on programs other than Social Security and could lead to unwise cuts or a failure to spend additional money where it should be spent. Once the GRH targets are met, however, it would, in my view, be highly desirable to gradually remove the Social Security annual surpluses from the reporting of budget balances. If by 1993, as called for by GRH, we have attained an approximate balance in the unified budget including Social Security, new targets should be set for a gradual reduction in the non-Social Security deficit.

If we do decide to continue the fund build-up inherent in present law, there may be additional things that could be done to make sure that the fund is protected and does in fact result in a net increase in national savings. There has been some experience with this matter in other countries. The Committee may wish to obtain the views of Alicia H. Munnell, Senior Vice-President and Director of Research at the Federal Reserve Bank of Boston on this. She and Nicole Ernsberger, a research economist at the Bank, have been studying how Canada, Japan and Sweden have attempted to insure that public pension fund surpluses are used to augment national saving and investment rather than to replace current taxes and pay for current general government outlays.

Mr. Chairman, I want to be very clear that although I see advantages for Social Security in large trust fund accumulations, I certainly do not consider them essential. The important issues related to reserve financing have less to do with Social Security than with value judgments about the relative weight to be given the interests of future residents of the United States as compared to those alive today, or the current interests of young workers over the next forty years versus their interests when they retire. But one decision point is clear cut: Partial reserve financing makes sense only if it adds to investment. There is no good argument for paying the current operating expenses of government with Social Security contributions rather than general taxes.

Social Security will work either as a partially funded system or a pay-as-you-go system. It can be designed as a pay-as-you-go system built on an inter-generational compact, with the retirement benefits of each generation paid by the one that follows, or it can be designed as a partly funded system in which each generation comes closer to paying its own way. To repeat: Social Security will work either way, and I hope the public does not come to believe that the future reliability of the system depends on this big trust fund build-up.

It would be too bad, for example, to have public faith in Social Security damaged if in the mid-1990s the Congress decided to shift part of the contribution rate from OASDI to the underfunded Medicare program and thereby moved the OASDI fund back toward pay-as-you-go. The loss in such a move, as compared to the additional Medicare funding that would otherwise be needed, would be a somewhat lower gross national product in the future (and a somewhat higher contribution rate for the OASDI program around 2025 or 2030), but it would work. In fact, Social Security has, in practice, worked for over fifty years on an essentially pay-as-you-go basis, although up until 1972 the system was theoretically on a partial reserve basis. Here is the history of the issue:

Whether to build a substantial reserve or not was argued strenuously in the early days of Social Security, and the issue was not consciously and finally settled. What we had up until the legislation of 1972 was a more or less pay-as-you-go system in practice and a sizable reserve system in theory. There were always contribution rates in the law scheduled to take effect later, which, if they had been allowed to go into effect, would have built big reserves. However, whenever the Congress got near the time an increase in rates would have produced reserves beyond those needed to cover short-term unexpected economic developments, contingency reserves, the increases were postponed. Nevertheless, the system was always balanced in the long-range actuarial estimates by taking into account the increases scheduled for the future.

In 1972, on the advice of the 1971 Advisory Council, the Congress openly adopted a pay-as-you-go approach. But at the same time, in order to keep the system in balance over the traditional 75-year period, the Congress put a rate increase in the law for 2011. This was a device to avoid putting a schedule of small rate increases in the law from 2011 on. It was assumed the one-time increase would be changed to a pay-as-you-go schedule as 2011 neared.

So it was pay-as-you-go in 1972.

In 1977 the system was underfinanced. To help meet the long-range cost the 2011 rate was moved up to 1990 even though it was recognized that the cost of the program would be relatively low in the 1990s. That change made building a sizable reserve a near-term possibility. The 1983 Amendments kept the 1990 rate and moved most of it up to 1988. Other 1983 changes also increased the projected fund build-up from what had been estimated in 1977.

Allowing the 1988 rate to go into effect, for the first time shifted the system in actual practice from pay-as-you-go to partial reserve funding. In my judgment, however, this was not so much a deliberate decision to abandon the theory of pay-as-you-go as a decision taken for other reasons. After the financial problems of the late seventies and early eighties a rate increase was needed to build back quickly to an adequate contingency level, and, moreover, if the rate increase had been reduced, the long-range financing of the system would have had to be reexamined because the system would no longer have been in close actuarial balance. The 1988 rate increase was also important for GRH purposes.

As its report clearly shows, the National Commission on Social Security Reform was concerned that OASDI financing be adequate over the whole 75 years for which the estimates are made. It did not, however, specifically consider, or express a preference for either a pay-as-you-go system or for partial reserve funding. It rather accepted all the financing provided by the law then in effect, including the 1990 rate increase, and then recommended ways to improve the financial position of the program.

The Commission members recognized that if they cut back on the 1990 rate increase, even temporarily, that more financing would be required later; given the size of the Social Security financing problem, no one favored giving up any financing already in the law. To a considerable extent, then, it was the 1977 decision to have a sizable rate increase in 1990 that led to the fund build-up we are now experiencing, rather than a calculated decision by the National Commission to give up pay-as-you-go and adopt reserve financing.

If the Commission had explicitly studied and adopted reserve financing, I doubt if we would have designed it the way it is. What we have now is a big build-up in the reserves, reaching a peak around 2030, and after that a gradual dissipation of the reserves to help pay benefits. The system is in close actuarial balance over the next 75 years, but by the end of the period the fund has disappeared.

A big build-up of reserves and then their liquidation might make sense if we were dealing with a one-time problem of a baby-boom generation that created a peak cost followed by lower costs. But that is not the situation. If we assume continuing improvements in mortality, as we should, and if we project continuing low fertility rates, which seems the best guess, the baby-boom generation does not cause a peak that later disappears. The baby-boom generation, rather, begins a new plateau of higher costs. The lower ratio of workers to beneficiaries which will occur when the baby boom retires will continue as mortality improves further and fertility stays low.

If we are going to build this reserve as called for by present law, I believe we ought to maintain it. One way to do this is to schedule a tax rate increase around, say, 2030 of about 1 percentage point for employees and the same for employers. Under this plan, the reserve continues to increase nominally but it drops relative to benefit payments, and at the end of the 75 years over which the estimates are made, the reserve equals about one or one and a half times the next year's outgo, a reasonable contingency reserve. Social Security could then continue on a pay-as-you-go basis but we would have had the advantage of two generations of increased savings, while avoiding after 2030 the need to redeem the bonds held by the Social Security trust funds. They would instead be a permanent income-producing resource for Social Security.

There is no hurry about deciding any of this. I believe the right course for the next few years is the same regardless of a decision about an earnings reserve for Social Security. The deficit in the unified budget should be reduced in any event, and the OASDI trust funds should be allowed to grow until they reach an adequate contingency level of, say, 150 percent of the next year's outgo, a level which is not projected to occur until the mid-1990s (actually, anywhere from 1993 to the latter part of the decade, depending on the assumptions).

All the possibilities should be studied and reported on by the statutory Advisory Council to be appointed soon by the Secretary of Health and Human Services, including the possibility of keeping OASDI more or less on a pay-as-you-go basis and shifting part of the OASDI contribution rate to Medicare once an adequate contingency reserve for OASDI has been reached. Such a shift would result in both OASDI and Medicare being adequately financed for the next 25 years without any increase in the combined OASDI and HI contribution rates, although a somewhat higher rate than presently scheduled would be required for both programs later on. The Congress can take its time to make these decisions. There is no good reason to hurry.

Whatever way the reserve issue is eventually settled, I do think it important after the GRH targets are met to get Social Security out of the definition of what constitutes a balanced budget. Counting Social Security annual surpluses in the definition results in pressure to increase those surpluses by benefit cuts. And that brings me to the next topic.

SOCIAL SECURITY AND THE DEFICIT

I don't see any good reason to consider Social Security in connection with short-term budget decisions, not only in this deficit situation but short-term budget decisions in general.

Social Security is a long-term program. People are paying today toward benefits they may not collect for 40, 45, or 50 years. It undermines confidence in Social Security to change the program because of short-term problems in the general budget. Then, too, it needs to be kept in mind that major cuts in the level of Social Security benefits are not likely to help the deficit over time anyway because such cuts would trigger corresponding reductions in Social Security income. It is unlikely that people could be persuaded to pay higher Social Security contributions than would be necessary to pay for the reduced protection, and since Social Security is in approximate long-range actuarial balance now, major reductions in protection call for corresponding reductions in contribution rates.

In 1983 things were different. There was a major problem in the Social Security system itself. The 1983 changes won general support because they were changes needed to make Social Security work, not to help solve a budget problem.

We are not in that situation now. Social Security is in good shape, and there is strong public support for the provisions as they are. I think we just ought to leave it alone, unless there are Social Security changes, desirable in themselves, that coincidentally help meet the deficit targets.

This hands-off position on Social Security has nothing to do with my belief that, of course, well-off older people, just as all well-off people, ought to have a part in solving the deficit problem. But why look to Social Security for this? Average retirement benefits under Social Security are only $525 a month; yet, two-thirds of older beneficiaries have Social Security as their major source of income. I would hope at some point the Congress and the President could agree on a higher income tax bracket or two and perhaps suspend the indexing of the income tax brackets until the budget is balanced. (I am not even sure the latter could be said to result in "new taxes" since it would merely continue the rates and brackets currently in effect.) In any event, higher progressive taxes seem to me the best way to include well-off older people in deficit reduction, not Social Security changes.

But my assigned topic is limited to Social Security changes and the deficit. Can anything sensible be done in Social Security that would help? Suppose someone came to me and said, "O.K., we don't care what you think about whether it is desirable to have Social Security involved in deficit reduction, but there is no way politically that we can develop a good reduction package without having Social Security in it. What would you do?" If that were the way the issue was presented, I would want first to rule out one approach that has received a lot of attention in the past, and then with some reluctance make three suggestions.

I believe it would be a serious mistake to make changes in the Social Security cost-of-living adjustment (COLA). I do not believe it makes sense to design a retirement system to pay lower benefits to people as they grow older, which is, of course, exactly what happens if the program pays less than a full COLA. Whatever level of benefits is considered desirable when first paid ought at least be kept up to date with purchasing power throughout retirement. Having said that, with some reluctance, I would then discuss three possibilities:

1. Extending Medicare and Social Security Coverage

One change that would clearly be desirable for Social Security and would also help the deficit as it is defined under GRH would be to make coverage universal. There is only one sizable group now left out of Social Security: the 30 percent of state and local employees (about four million people) who have not been brought in under the voluntary provisions in present law.

It is very unfair to the rest of the population to leave this group out of Medicare. (New hires are covered under Medicare but the majority of the 4 million are not.) Most state and local employees pick up the minimum coverage that is needed for Medicare in jobs other than their state and local jobs or they are covered as dependents of those eligible for Medicare, but they don't pay for Medicare throughout their careers as everybody else does. They are getting exactly the same package of benefits with less payment. That is clearly unfair, and it costs the system money. Over five years, coverage of this group would increase Medicare income about $9 billion, which would help both Medicare and the deficit.

In the OASDI program, I think the policy for these state and local employees ought to be the same as present policy for federal employees, that is, all new employees should be covered under Social Security, with state and local plans modified as desirable to build on top of Social Security like all other retirement systems. Over the next five years this would increase OASDI income about $8 billion and help the deficit by this amount.

2. Moving Back Toward a Retirement System

The original idea in Social Security, which I still believe to have been largely correct, was to pay benefits only when there had been a loss of earnings due to retirement in old age, the death of a wage earner and later the total and long-term disability of a wage earner. This concept has been preserved in the case of disability--benefits are paid only if a worker is unable to perform substantial gainful activity. But the concept in the case of retirement has been whittled away at for so long that it now amounts to very little.

Originally retirement benefits were paid only if earnings were below $15 a month (1939). Gradually this amount was raised. As earnings rose it seemed reasonable enough to consider people retired who earned up to $50 a month (1950) and then $75, $80 and by 1958 $100 a month. And the higher the amount went, the more troublesome it seemed to make the loss of a whole month's benefit depend on earnings just over a specified dollar amount--so the concept of a dollar reduction for each two dollars earned above an exempt amount was born in 1960, and the transformation of the test into one of gradual or partial retirement was completed.

And then came coverage of the self-employed which required an annual test for them (1950) since self-employment net income cannot reasonably be computed on a monthly basis. Later (1978) the monthly test was eliminated for wage earners, too. By now the test has become very complex to understand and to administer. Why and how benefits are withheld is very mysterious to most beneficiaries, and many limit their earnings to the wholly exempt amount, not wanting to risk going off the benefit rolls wondering when and if they will start getting benefits again.

Coverage of the self-employed also introduced the idea of paying benefits at a specified age without regard to work--75 at first (1950), later 72 (1954) and 70 (1977). The idea of paying without a retirement test after a specified age came in because lawyers, doctors and other self-employed persons argued that many of them never retire and would get nothing for their contributions. So the program was continued as insurance against wage loss up to a certain age and then became a straight annuity after that age--regardless of retirement.

Finally as a result of the 1983 Amendments, the reduction of $1 in benefits for each $2 earned above the exempt amount will be changed in 1990 to a reduction of $1 for each $3 earned, and over time the law will grant a full actuarial increment of 8 percent a year for work between ages 65 and 70.

To reduce the cost of Social Security, and incidentally contribute to meeting GRH targets, one could move back toward the earlier idea of paying benefits only to those who have lost earnings by reason of retirement. I know there are important arguments against this, but, in my judgment, it would be one of the least damaging ways to save Social Security money, if that becomes the question.

The increment for work between 65 and 70 could be held at 3 percent instead of having it go up gradually to 8 percent by 2005. And the test of what retirement means could be tightened up by deleting the indexing of the exempt amounts and holding deductions at a 2 to 1 rate rather than going to 3 to 1. These are all changes in provisions that have not yet gone into effect and, while affecting expectations, do not roll back any benefits already granted. The savings from such changes would be in the range of $5 to $10 billion over the next five years and more later.

With fewer new entrants in the labor force, it may soon be in the interest of employers to retain and hire more older workers. An argument can be made that Social Security ought to benefit financially from any such employment that may result. Under present law, when the 8 percent increment is in effect, Social Security will incur the full cost of paying benefits at 65, even though the payment is postponed until 70.

I am concerned, too, that public support for Social Security might erode somewhat if we pay 25 percent higher benefits than we have been to those who work to 70, as we will under present law. Such workers tend to be the better-off and the justification for such an increase is weak. I should acknowledge in this regard that I did support the 1983 changes within the National Commission on Social Security Reform, and I am not anxious to reopen these old arguments. I put this thought forward with considerable reluctance.

3. TAXING MORE OF THE BENEFIT OF HIGHER-INCOME BENEFICIARIES

Finally I would say that there is a good case for taxing more of the Social Security benefits of higher-income beneficiaries. The problem is that the burden would fall on the same group being asked to pay the income-related premium for the new catastrophic health plan. There is a real question about how soon and how often you should ask the same people to pay higher taxes.

But on the merits and taken alone, there is a good case for taxing more of Social Security benefits. Tax policy for Social Security should be the same as that applied to all other retirement systems. The recipients of other pensions pay a tax on benefits that exceed his or her own contributions (which have been previously taxed.) If this theory were applied to the Social Security benefits of higher-income people, they would be taxed on about 85 percent of their Social Security benefits instead of the 50 percent on which they now pay a tax. This change would raise about $16 billion over five years.

There really isn't any good reason why Social Security was treated differently from other retirement benefits from the beginning. The complete exemption of benefits from taxation, which lasted until the 1983 Amendments, was an accidental result of the way the program was designed. There was real concern back in 1935 as to how the Supreme Court would view a federal program of social insurance requiring contributions and basing benefits on those contributions. Consequently, the benefit provisions and the taxing provisions were kept completely separate and established in separate titles of the Social Security Act. There was no doubt about the taxing power of Congress or its authority to pay benefits, but some thought there was a problem in connecting the two, so the strategy in the presentation to the Supreme Court was to separate the taxes and the benefits. When the Treasury looked at the law, it followed that same reasoning in determining how the benefits should be treated for tax purposes. Since the benefits were not connected to the contributions paid, they were determined to be a "gratuity," and gratuities are not taxable to the recipient. There was no statutory base for exempting Social Security benefits from taxation, just this rather dubious ruling by the Treasury.

In any event, beginning in 1983, the tax treatment of Social Security has become a matter of statute, and there is a good case for taxing more of the benefit. For at least 25 years I have favored taxing Social Security benefits as other pensions are taxed. I believe it strengthens the perception of the benefit as earned and is one more way of distinguishing Social Security from welfare and associating it with other payments growing out of work, such as wages and pensions. It is not a gratuity and it should not be treated as one for tax purposes.

I believe taxing more of the Social Security benefit would be better accepted if the proceeds went back into the Social Security funds as is the case with the part now taxed. Perhaps the proceeds should go to the under-funded Medicare program.

So far I have said very little about possible cuts or savings in hospital insurance. My own impression is that cutting reimbursement of hospitals further would not be desirable and in all likelihood would result largely in shifting hospital costs from Medicare to other payers, principally those covered by private insurance. On the other hand, I do think more can be done about reducing the rate of increase in the costs of Part B. I know that the Physician Payment Review Commission is studying new ways of establishing fee schedules based in part on the development of relative value scales. In itself a fee schedule does not reduce costs, but it could be made to do so if there are also volume controls to prevent physicians from performing more procedures as fees are held down. I would hope if fee schedules are introduced they would be accompanied by provisions that would require physicians to accept the scheduled fee as full payment for Medicare services. Otherwise any reduction in payment by Medicare could end up by being shifted to patients.

I don't know that there is much more to be done immediately about holding down Medicare cost increases. At one time I would have suggested a reduction of the general revenue financing of Part B of Medicare since, it has seemed to me, that a 75 percent general revenue payment was not justified for the group of beneficiaries that are relatively well-off. However, the income-related premium in the Catastrophic Health Protection Act of 1988 effectively charged the well-off beneficiaries more than the catastrophic protection is worth, and thereby has effectively reduced what they get from the general revenue contribution to Part B.

I know the income-related premium has become controversial, but it seems to me that the theory was right. In one way or another, relatively well-off Part B beneficiaries ought to be paying more of their own way under Medicare, considered as a whole. They have little basis for being upset because they are paying "too much" for a new addition to the program when general revenue pays such a high proportion of their old Part B benefits. I would hope the Committee will not spend money to relieve the relatively well-off from what they are required to pay for catastrophic protection, unless at the same time you introduce a way to have them pay more for their old Part B benefits. Looking at Part B and catastrophic protection together, the well-off elderly are not paying too much. Moreover, I think many of those protesting are failing to take into account that their supplementary Medigap protection should cost less than it would otherwise because of the addition of catastrophic coverage to Medicare.

In the long run, there are certainly savings to be made in Medicare and health care generally. The fact that, even with great gaps in coverage, we are currently paying 11.3 percent of our gross national product for health care--more than any other nation--tells us there is fat to trim. Increased efforts to control unnecessary services are clearly worthwhile. So are efforts to prevent illness from occurring in the first place.

There are savings to be realized, too, from the efforts of the Department of Health and Human Services to determine which medical procedures work and which do not, so that Medicare can pay only for efficacious treatment. Limiting payments to hospitals on the basis of diagnosis has helped control the length of hospital stays. And we can certainly save by simplifying the administration of health insurance. After a quarter of a century of experience with Medicare and Medigap we ought to be able to attack and resolve many of the needlessly complex arrangements that force beneficiaries, hospitals, physicians and other providers to struggle with seemingly endless forms and requirements.

In the long run, savings should also result from accelerating research on the causes of the diseases affecting the elderly, particularly heart, cancer, stroke and the chronic ilnesses of old age--such as Alzheimer's disease, arthritis, osteoporosis, conditions causing incontinence, and so on. Aside from humanitarian considerations, it just makes good business sense to invest in this kind of research as a way to control the cost of Medicare and Medicaid and other insurance programs.

When all is said and done, however, there is a limit to what can be accomplished by strategies to save money. In the long run Americans are going to be paying more, not less, for health care. Costs are driven in part by our ability to do things in medicine that we couldn't do before--joint replacements, heart bypass operations, organ transplants and other manifestations of high-tech medicine--but also by doing better what we had been doing, as in the case of cataract operations, thereby justifying more widespread use of these procedures. Hardly a month passes without new medical discoveries, some of which save money but which on the whole add to cost even though they improve health care.

Equally important, demographic and socioeconomic trends are combining now to create future costs that are likely to be higher than those we have thus far experienced. Demographic trends may be more or less inexorable, but socioeconomic trends are another matter. An aging society must, of course, anticipate major health-care cost increases. That much is unavoidable. We do not, however, have to accept as inevitable the costs associated with denying adequate health protection to millions of children in families that cannot afford health insurance. But as long as we do--as long as we are willing to tolerate broadly unmet needs such as prenatal care, preventive health services, dental--care and mental health care--we face the prospect of paying higher bills in the future.

Sooner or later (preferably sooner) we must confront the developing shortfall in Medicare Part A funding that will, unless corrected, jeopardize the hospital insurance program. And an even greater challenge is the question of what to do about the more than 50 million people under 65 who either have no health insurance at all or who are grossly underinsured.

Mr. Chairman and Members of the Committee, I greatly appreciate the opportunity to discuss these important matters with you.

Mr. **Stark** [presiding]. Mr. Myers.

STATEMENT OF ROBERT J. MYERS, SILVER SPRING, MARYLAND (FORMER CHIEF ACTUARY OF THE SOCIAL SECURITY ADMINISTRATION)

Mr. **Myers**. As you well know, the Social Security program of old age survivors, and disability insurance is now in excellent financial health. The trust fund balances are about three times as large as they were estimated to be when the 1983 legislation was enacted.

This favorable picture looks as though it will certainly continue for a number of years to come. However, under the present method of financing, these huge excesses of income over outgo each year over the next 20 years will build up a very large fund.

I would like to point out, that I use the phrase, "excess of income over outgo," and not "surplus". The latter phrase gives the general public the idea that this is extra money over what was anticipated and it, therefore, can be spent. Under the financing method established for the program, all these excesses of income are counted on to build up a fund that will become a very mammoth size, some $12 trillion, by about the year 2030.

Then oddly enough, it will be depeleted in the next 20 years. I am constrained to say that this procedure of building up a mammoth fund balance and then dissipitating it just does not make good sense, especially because the program's cost does not decrease after the baby boomers pass from the scene, but will be, as Mr. Ball says, at a new plateau.

The hospital insurance program at the moment is in relatively good financial shape, in having more income than outgo, but it looks likely that, 4 or 5 years from now, this situation is going to change, and it will be running annual deficits of income versus outgo.

I think for this very reason that it would be very desirable for the Congress to reexamine the financial structure of the hospital insurance program and put a tax rate schedule in the law that would make the system be in long-range balance over the next 75 years.

There are several myths about financing the Social Security program that I would like to talk about next. The first is the one that Mr. Ball brought out—namely, that the National Commission on Social Security Reform, and then the Congress, decided to build a big fund to take care of the baby boomers and then let that fund vanish as the baby boom population passed from the scene.

This just is not so. Mr. Ball wasn't absent from the room when this was discussed, because it was not discussed. The commission just did not go into that subject very thoroughly, the reason being that right ahead of it was the iceberg that by the middle of 1983, if nothing were done, benefit checks would not go out on time.

The Commission concentrated on the financing situation in the 1980's and also looked at the long run, on the average, without seeing how the year-by-year picture ought to be. I think that the commission did this, knowing the general long-range situation, but also knowing that there would be ample time to look at the matter later on. I think that now is the time when it should be looked at.

The second myth that often circulates is that, in order to balance the budget or nearly balance the budget, we ought to cut the benefits of the Social Security program on a permanent basis, and that this will then help to balance the budget. This just is not the case, because Social Security being a long-range, self-supporting system, if the benefits are reduced, then the taxes to support the benefits should also be reduced. So, from the budget standpoint, including the Gramm-Rudman approach, you are right back where you started from.

I think there are serious disadvantages in building up a mammoth fund balance over the next 30–40 years. I can see the need for greater national savings, but I do not think that is the role of the Social Security system.

I think that these disadvantages are more of a political nature than an actuarial nature. For one thing, I think that, if there is a large fund buildup in Social Security, this availability of money that can easily be borrowed by the Government could encourage excessive governmental spending.

Second, I think that perhaps even more important, with a very large fund balance building up in the next decade, there will be almost irresistible pressures from beneficiaries throughout the country to liberalize benefits and say "look at all that money you have there. You have hundreds of billions of dollars. Surely, you could increase benefits by 10 percent. Why be so stingy?"

Obviously, if benefits are increased in the next decade or two, that is going to have a long-range effect. When the baby boomers later come on the roll, the financing problems of that day will be even greater.

Now, what should be done about Social Security and Medicare in relation to the budget deficit? I believe that the foremost change which should be made is to remove, as soon as possible, the operations of the Social Security and Medicare programs from the computation of the Gramm-Rudman targets.

Perhaps there would need to be different targets, but I think that then this should be legislated. I think that if this were done, the deficit situation would be portrayed vividly and honestly, whereas now I think that there is great confusion and masking of the real facts of life by counting Social Security and Medicare in the budget.

You might ask then how are we going to handle huge deficits which are really present now, but are disguised? I think that the solution is simple if the financing of the Social Security program is revised so as to be on a pay-as-you-go financing basis.

I would lower the tax rate for OASDI to 5.7 percent each for employer and employee, as prevailed before 1988. I would not let the tax rate increase again in 1990, as it is now scheduled. That 5.7 percent rate could be held for a number of years.

The trust fund would build up under this lower scheduled rate. By 1995 you could have another, perhaps slight, reduction in the tax rate. What do you then do about the budget situation? What I would propose is that both personal and corporation income taxes should be increased slightly, so as to produce the same amount of revenues in the aggregate as the reduction in Social Security taxes which I propose.

The total tax burden on the Nation would be no different. In other words, there would be no real tax increase in the aggregate. But the picture of what is going on would be clear to all. The incidence of the tax burden would be more progressive, to the extent that there would be a shift from payroll taxes, which taken alone are of a somewhat regressive character, to income taxes.

I have one suggestion to make in the OASDI program that would help the general budget situation. By chance, it happens to be the same as Dr. Aaron and Mr. Ball said. I believe that 85 percent of Social Security benefits should be subject to income tax.

Fifteen percent represents approximately as much as anybody has paid for their benefit out of their own taxes. I would go along with Mr. Ball and say, for purposes of expediency, that the present thresholds should be retained, but I would certainly increase the 50 percent taxable portion that is in present law up to 85 percent.

One important feature, however, that neither Mr. Ball nor Dr. Aaron mentioned is what happens to the proceeds? I would strongly suggest that the proceeds of the additional taxation should go into the general fund of the Treasury and stay there—not, as at present and as was part of the 1983 consensus package, go back into the Social Security trust funds.

If this were done—namely, that the taxes that would be raised by going from 50 to 85 percent stayed in the general fund—it would truly reduce the budget deficit.

Now, turning to the Medicare program, I believe that the hospital insurance trust fund and the supplementary medical insurance trust fund, as well as the new catastrophic drug insurance trust fund, should all be removed from the general budget. This probably also should be done for all other trust funds involving benefit payments, such as the civil service retirement and military retirement systems.

As to taxation of Medicare benefits, I originally thought that was an excellent idea, just like taxing the cash benefits. But, in essence, the Congress has already done that indirectly through the new Medicare Catastrophic Coverage Act. So, I do not believe that there should be any further income taxation of Medicare benefits.

One problem exists with regard to the supplemental premiums—or in other words, the surcharge on income taxes—that has not yet been widely recognized. The manner in which this provision operates will create a new variety of notch babies. I am certain that the Congress does not want to hear about notch babies any more, but I would hope that a new variety can be prevented from occurring.

The way that the law is now written, anybody who is eligible for hospital insurance for 6 months or less in a year—in other words, people who become age 65 in July or afterwards—pay no supplemental premium. The person who is eligible for more than 6 months pays the full premium. So somebody who reaches age 65 on June 30, 1989 pays up to $800. If they were born a day later, they would pay nothing. That notch of $800 is going to really affect some people, and I think that the Members of Congress are going to hear about this then. Also, the person who dies on June 30 pays no supplemental premium. If the person dies on July 1, there can be an $800 supplemental premium.

What I suggest is the obvious thing that easily can be done administratively and logically—namely, to make the supplemental premiums be on a pro rata basis, depending on how many months in the year the person is eligible for hospital insurance benefits. No sharp notches would occur then between essentially similar people. We can well do without having Medicare notch babies.

Mr. Chairman, that concludes my testimony.

[The statement of Mr. Myers follows:]

STATEMENT BY ROBERT J. MYERS PRESENTED TO THE COMMITTEE ON WAYS AND MEANS, HOUSE OF REPRESENTATIVES, FEBRUARY 9, 1989, WITH REGARD TO THE BUDGET DEFICIT

Mr. Chairman and Members of the Subcommittee: My name is Robert J. Myers. I served in various actuarial capacities with the Social Security Administration and its predecessor agencies during 1934-1970, being Chief Actuary for the last 23 of those years. In 1981-82, I was Deputy Commissioner of Social Security, and in 1982-83, I was Executive Director of the National Commission on Social Security Reform. This statement is made in my personal capacity.

Necessity for Budget Reduction

The need for budget deficit reduction cannot be said more clearly than the Chairman's statement in the announcement of these hearings: "I am seriously concerned about our Nation's economic future and believe that we need to move as quickly as possible to reduce the Federal budget deficit."

My testimony will deal with the relationship and effects between the Social Security (Old-Age, Survivors, and Disability Insurance--OASDI) and Medicare programs and the budget deficit.

Financial Status of OASDI and Medicare Programs

The OASDI system is currently in excellent financial health. The assets of the OASDI Trust Funds at the end of 1987 amounted to almost $69 billion (and were about $110 billion at the end of 1988). The balance at the end of 1987 was $48 billion higher than was estimated for that date in the pessimistic (Alternative III) estimate made when the 1983 Amendments were enacted -- on which estimate the short-range financing (for the 1980s) was founded in the legislation. Such excess of actual over estimated fund balance was $35 billion for the intermediate (Alternative II-B) estimate.

Under current law, large annual excesses of income over outgo -- which cannot properly be referred to as "surpluses" -- develop in the next three decades under OASDI. Such excesses, under the intermediate estimate, amount to about $45 billion in 1989, $60 billion in 1990, and increasingly larger amounts thereafter (e.g., $110 billion in 1995 and $185 billion in 2000). As a result, very large fund balances will be built up during the next four decades. The fund ratio -- which is the fund balance expressed as a percentage of the next year's outgo -- peaks at 531% in 2015, when it is estimated at $6.8 trillion in current dollars, or $2.3 trillion in 1988 dollars. After 2015, the fund balance continues to grow in terms of current dollars, reaching a peak of about $12 trillion shortly after 2030. Under the pessimistic assumptions, the fund balance in 2015 is $3.4 trillion in current dollars, or $0.9 trillion in 1988 dollars.

After the end of the build-up period, the assets of the trust funds will be drawn upon, and they will be exhausted shortly before 2050. At that time -- if the benefit provisions are left unchanged -- additional financing in the form of higher payroll tax rates will be necessary. These increases would, on the basis of the intermediate-cost estimate, be 1.8% for both the employer and the employee over the rate now scheduled for 1990 and after -- not an unmanageable rise.

No legislative intent has seemed to have been present, or expressed, to change over to this funding basis from the current-cost approach adopted in 1972 and supported over the subsequent years by the Board of Trustees. I am constrained to say that this procedure of building up a mammoth fund balance and then depleting it does not make good sense, especially when the program's cost (as a percentage of taxable payroll) is just as high in all years after 2030 as it is then.

The Hospital Insurance program (HI) is currently in excellent financial health. The trust-fund balance at the end of 1987, amounting to $54 billion, was $41 billion higher than the pessimistic estimate for that year which was made in 1983, and $33 billion higher than the corresponding intermediate estimate. The balance at the end of 1988 was about $75 billion. Surprisingly, the cost rate has been slowly decreasing over recent years -- rather than increasing, as was anticipated in 1983. However, this favorable trend is expected to last for only a few years, and then significant increases will occur each year.

The favorable recent trend for HI, which in 1983 was expected to have its trust fund about exhausted by now if conditions were pessimistic, has been due, in large part, to reducing reimbursements to hospitals and controlling utilization of services. How much this can be augmented in the future without endangering hospitals' financial conditions or providing inadequate services to patients is a question.

The HI Trust Fund will, according to the intermediate estimate, have sizable excesses of income over outgo in the next 5 years -- about $15-20 billion in 1989 and somewhat smaller amounts thereafter.

The Supplementary Medical Insurance program (SMI), when considered on a 1-year term insurance basis -- as it should properly be -- is in good condition. On an incurred basis, the fund balance at the end of 1987 ($5.5 billion) was 9% less than its liabilities. However, this small deficiency was more than eliminated in 1988, as a result of the large increase in the enrollee premium rate (and thus in the matching payments from the General Fund). Because of its financing basis, SMI will not have large excesses of income over outgo in future years -- and so it is not a major influence in the budgetary process.

Relationship of OASDI and HI to the Budget

The manner in which, under present law, the OASDI Trust Funds first build up huge amounts in the next four decades and then decrease over the next two decades until being exhausted would have significant, deleterious effects on public-debt management and on Budget operations.

The relationship between the operations of the OASDI and HI Trust Funds and the Budget is frequently misunderstood by the general public. Beginning in fiscal year 1986, the operations of the OASDI Trust Funds have been out of the Unified Budget, so that any excess of their income over outgo does not reduce the Budget deficit. However, anomalously, these trust-fund excesses of income over outgo are counted to meet the Gramm-Rudman-Hollings targets for Budget-deficit reduction. The result is thus virtually the same as if these trust-fund operations were included in the Budget, but the imbalance is really still there, and the National Debt is increased by the amount of the trust-fund excesses of income over outgo. In other words, the result of this procedure is, in the short run, to make the targets easier to meet and thus to make the Budget deficits appear smaller than they really are. On the other hand, the operations of the HI Trust Fund are fully included in the Budget until FY 1993, when they will be completely removed. The operations of the SMI Trust Fund are, at all times, included in the Budget.

Widespread Fallacies about Financing Basis of OASDI

One myth is that the National Commission on Social Security Reform, in its recommendations which led to the 1983 Amendments, intended to have the system accumulate a huge fund while the baby boomers are employed, and then draw it down.

This was by no means the thinking of the Commission when it made its recommendations. Nor was it the intention of Congress when the legislation was enacted. No reference to any such intention can be found in the Commission's report or in the congressional debate.

Moreover, the information about the huge growth in the trust-fund balances had not been available when the Commission made its consensus recommendations, or even to Congress later when considering the legislation. Such figures were actually not available until mid-1983, although those with actuarial knowledge realized earlier that the approach taken would result in trust-fund buildups.

The Commission developed its recommendations by ensuring, as much as possible, that the year-by-year financing in the 1980s would be adequate and that, over the long range and on the average, sufficient financing would be provided. As is well known, the use of averages can be deceptive. That certainly is the case in this situation, as compared with looking at the year-by-year development of the trust-fund balances over the long run.

It is fair to say that the Commission knew that, once the short-range problems were solved--as they certainly have been--then a closer look should be given to the long-range situation. This should be a major function of the statutory Advisory Council on Social Security, which is to be named soon.

Accordingly, the building up of a huge fund that would peak in the midst of the baby boomer's retirement was a coincidence--or, at most, an unintended by-product of the recommendations.

A second myth arises when it is proposed that the Budget deficits should be reduced by making long-term permanent reductions in OASDI benefits, such as reducing the COLAs or making the benefits subject to a means test. As indicated previously, because OASDI is not included in the Budget, such effect would not actually occur, although the Budget targets would be more readily met. Again, this seems to be a matter of deceiving ourselves. Perhaps even more importantly, because OASDI is financed on a completely self-supporting basis, any reduction in long-range benefit costs should correspondingly produce reductions in the tax rates required to support the system. The net effect of this action and reaction is essentially counterbalancing. Thus, insofar as the Budget is concerned (even including the Gramm-Rudman-Hollings targets), nothing would really be achieved thereby.

Dangers Inherent in Build-Up of Mammoth Balance in OASDI Trust Funds

The disadvantages of building up mammoth balances in the OASDI Trust Funds are more of a "political" nature than of a theoretical, actuarial nature. One problem would result from the huge amounts of investments involved, which could absorb a very large portion of the National Debt (or even all of it) and thus not leave sufficient for the general investment market. Another problem might be that the ready availability of large amounts of money that could easily be borrowed by the General Fund of the Treasury would encourage excessive governmental spending.

Yet another problem is that the presence of a very large fund balance could create politically irresistible demands for greatly liberalized benefits on the grounds that "all that money is there". The difficulty, then, if such liberalization did occur, and the fund balance were drawn down, would be that OASDI costs in future years would be greatly increased over those under present law -- and the long-range financing problems would become greater.

Desirable Changes in Social Security and Medicare in Relation to Budget Deficit

I believe that the foremost change that should be made is to remove the operations of the Social Security program from the computation of the Gramm-Rudman-Hollings targets for the Budget deficit reductions. The deficit situation would then be portrayed vividly and honestly.

But then, one would say, how do we handle the huge deficits -- which really are present, but are now disguised? The solution is simple if the financing of the Social Security system is revised to be on the proper basis of pay-as-you-go financing -- by lowering the tax rate for 1990 to 5.7% each for the employer and the employee -- instead of increasing it, as present law provides, from the 6.06% applicable in 1989 to 6.2%. Then, both personal and corporation income tax rates should be increased slightly so as to produce about the same amount of revenues in the aggregate as the reduction in Social Security taxes.

The total tax burden on the nation would then be no different, but the picture of what was going on would be clear to all. And the incidence of the tax burden would be more progressive to the extent that there would be a shift from payroll taxes -- which, taken alone, are somewhat of a regressive character -- to income taxes.

If OASDI is financed on a pay-as-you-go basis, payroll tax rates would be lower than now scheduled for the next 30 years. However, somewhat higher rates would be required for the following 30 years, but the eventual rates ultimately will be about the same -- or even a little lower, because a small fund will be maintained, as compared with none under present law. A possible tax-rate schedule for pay-as-you-go financing is shown in Table 1.

I have one suggestion with regard to a change in the OASDI program that will contribute to the solution of the Budget deficit problem. At present, up to 50% of OASDI benefits are subject to income tax when adjusted gross income, plus non-taxable interest on state and local government bonds, plus 50% of OASDI benefits exceeds certain fixed thresholds. The proceeds of such tax go to the OASDI Trust Funds, rather than to the General Fund, to be used for general budgetary purposes. This was one of the financing measures adopted in the 1983 reform legislation.

In theory, OASDI benefits should be taxed in the same manner as any other contributory pensions -- namely, on the amount received in excess of the person's contributions that were made from after-tax income. At present, few OASDI beneficiaries have so "paid for" (on an actuarial basis) more than 15% of their benefit. Accordingly, it would be quite fair to tax 85% of the OASDI benefits. In the interest of helping relatively low income persons, it probably would be desirable to retain the thresholds, and even to continue to add only 50% of OASDI benefits to other income to determine the taxable amount above the threshold if such excess is less than 85% of the benefits.

The additional income taxes that would be collected under my proposal should not go to the OASDI Trust Funds, but rather to the General Fund. Thus, they would result in true Budget deficit reduction.

Now turning to the Medicare program, I believe that the operations of the HI Trust Fund should be removed from the Budget as soon as possible, just as would be done for the OASDI Trust

Funds and as will be done anyhow under present law beginning in FY 1993.

There seems to be no need to subject Medicare benefits above those "paid for" by taxes and premiums of the beneficiaries to income taxes, because this has already been done, in substantial part in essence, by the so-called supplemental premiums levied as a result of the Medicare Catastrophic Coverage Act of 1988. Such premiums are income-tax surcharges, payable by beneficiaries with substantial income tax liability.

One problem exists with regard to these supplemental premiums that has not yet been widely recognized. The manner in which this provision operates will create a new variety of notch babies! The supplemental premium is not payable by those who are eligible for HI benefits for less than 7 months in a taxable year. As a result, a person who reaches age 65 on July 1, 1989 has no supplemental premium to pay, whereas one who was born a day earlier would have a premium of as much as $800. The same situation occurs in all future years for persons attaining age 65 then, and with ever-larger dollar amounts involved. It also occurs for new disability beneficiaries, and for all beneficiaries in the year of death.

This Medicare notch can be solved quite simply -- and in a revenue-neutral manner too. The supplemental premium in the first and last years of eligibility should be determined on a pro rata basis. Thus, persons first becoming eligible in the last month of the taxable year would pay no supplemental premium. Those becoming eligible in the next-to-last month would pay 1/12 of the supplemental premium, etc.

This basis for the supplemental premium would result in some persons paying less than under present law, and others paying more. It would, however, be equitable and have relatively smooth transitional results. No sharp notches would occur as between essentially similar people. We can well do without having Medicare notch babies!

There is no question that, over the long range, the HI program is significantly under-financed. As soon as possible, and at the very least, a tax-rate schedule should be legislated that will adequately finance HI over the 75-year valuation period according to the intermediate estimate. If it is desired to solve the financing problem by some benefit reduction, without affecting current and near-future beneficiaries or reducing the scope of benefit protection, I suggest that the minimum age for non-disabled beneficiaries should be set at the Normal Retirement Age for OASDI -- so that the two programs move in tandem; a correspondingly lower tax-rate schedule would then be necessary.

I fully realize that the future experience of HI is subject to great variability -- more so than OASDI. As a result, any tax-rate schedule established now will undoubtedly need to be altered as future experience unfolds. Certainly, a revised basis along the lines indicated will present a more accurate picture to the general public and will allay the fears of "certain bankruptcy".

PRESENT AND PROPOSED SOCIAL SECURITY TAX RATES[a] FOR EMPLOYERS AND EMPLOYEES (each)

Period	Present Law	Proposal	Difference
1984-87	5.7%	5.7%	--
1988-89	6.06	6.06	--
1990-94	6.2	5.7	- .5%
1995-2014	6.2	5.1	-1.1
2015-19	6.2	6.0	- .2
2020-24	6.2	6.8	+ .6
2025-48	6.2	7.6	+1.4
2049 and after	8.0[b]	7.7	- .3

[a] These rates do not include the tax for the Hospital Insurance portion of Medicare -- currently, 1.45% (and so scheduled for all future years). Also, in 1984, the employee rate was reduced by a tax credit of 0.3%.

[b] Rate necessary to finance scheduled benefits.

Mr. PEASE. Thank you, Mr. Myers. We are indebted to you for that excellent testimony. I would like to ask a few questions myself.

Dr. Aaron, you mentioned—I guess all three of you mentioned—we really ought to take Social Security off the budget for Gramm-Rudman purposes and try to balance the remaining part of the budget so that we are not fuzzing up the issue. I guess a concern I have in light of the very large excess collections which Social Security will pick up in the coming years is whether we would not run the risk of taking too much money out of the economy. Might we not risk slowing down the economy if we use the Gramm-Rudman process to balance the Federal budget without taking Social Security into account? Wouldn't that be the same as taking another $450 billion out of the economy for the Social Security trust fund?

Mr. AARON. That is an important question and comes up frequently when this issue is discussed. The critical question is whether running these kinds of surpluses would slow the economy. Would total private and public saving be excessive?

That is not a clear and present danger, alas. The national savings rate is now below half of what it was for the 30 years following the end of World War II, running through 1980. I can imagine situations in the future where conceivably we would experience a new rebirth of private sector frugality, with private businesses and individuals wanting to save a whole lot. In such an event, the kinds of withdrawals that Federal budget surplusses would represent could conceivably act as an excessive drag on the domestic economy. I hope one day we face such a problem.

Mr. PEASE. Thank you.

I will ask Mr. Myers and Mr. Ball not to respond, since I am on my 5 minute time limit.

I am very interested in the statement of Mr. Ball and I think supported by Mr. Myers, that we don't have to build up these huge surplusses. They were not envisioned. We could well go on a pay as you go basis. It seems, though, that if under present circumstances we are going to build up the surplus to say $12 trillion by 2020 or 2030, and then dissipate that whole $12 trillion over the following 20 or 30 years that logically there has got to be a huge excess of expenditure over current revenue coming into the Social Security trust fund during those 20–30 years.

I guess my question is if that $12 trillion is not there, to be parceled out to the tune of tens of billions of dollars a year to cover that difference between current outgo and current income, how much would Social Security tax rates have to go up to generate that kind of income or that kind of revenue?

Mr. BALL. I think this will meet what you have in mind. I suggested that to maintain those reserves at their peak—in other words, to substitute Social Security taxes for a dissipation of the reserves, putting in a tax rate instead of cashing in bonds, that about 1 percentage point increase for the employers and 1 percentage point increase for employees would be needed. In what I am suggesting, interest earnings on the reserve would also be available so it isn't a full substitution for reserves, but to prevent the dissipation of the reserve, about 2 percent of payroll would be enough.

Mr. Myers suggested that a complete subsitution would be about 1.80 each, I believe.

Mr. Myers. That is correct.

Mr. Pease. One point eighty each?

Mr. Ball. Yes.

Mr. Pease. All right. I appreciate that. If Social Security is investing in Government instruments which are helping to finance our current expenditures for other things—defense or whatever—then eventually when we hit the peak and we are on our way down in writing that $12 trillion surplus out, I presume the Social Security fund would have to redeem those Government instruments and at that point, it would be a very substantial addition to the Federal deficits on top of the interest that we are paying on those instruments. Am I correct in that statement?

Mr. Aaron. Additional taxes would have to be levied to redeem those bonds if, indeed, we ran down the surplus. But I would like to reinforce the point that Mr. Ball made and I think Bob Myers would also agree—if we build up that reserve, we should do so not because we plan eventually to run it down, but because we recognize that we need, an addition to national savings—which should be continued on into the future not dissipated at some time down the road. We have done some calculations at Brookings that indicate that if we continue the current methods of calculating actuarial balance in the Social Security system, it is most unlikely that we will in fact, deplete those reserves.

Sometime in the 1990's, looking ahead 75 years from that new vantage point, we will discover the system is in long-term deficit. At that point, if we are to maintain actuarial balance measured over 75 years, we will either cut benefits or raise taxes, and in so doing, we will delay, put off a bit further, what appears then to be the decumulation of reserves. The deficit will reappear later, and each time that long run deficit reappears, we will cut benefits or raise taxes, thereby preventing effectively the decumulation of the reserves we built up.

We could eliminate the surpluses, of course, in the manner that Mr. Myers suggests, by going immediately to pay as you go financing.

Mr. Ball. Or you could put in a one time rate increase in 2025 or 2030.

Mr. Aaron. That is right. That would require a larger tax increase than one to maintain balance. That would be necessary if the tax increase took effect in the near future. And it would then mean that the trust fund, instead of starting to decline around 2030, would continue growing, as Mr. Ball suggests.

Mr. Pease. Thank you very much.

Mr. Matsui.

Mr. Matsui. Thank you, Mr. Chairman.

I would like to pursue that a little further, Mr. Ball, and Mr. Myers, and Mr. Aaron, to the extent you would like to comment on it.

I thought when we reformed the Social Security trust fund in 1983 that one of our major concerns, and the reason we had to build the surpluses, was the demographic change that will occur in the country. The number of employees per retiree in the work force in the year 2030 will be just under three for each retiree, whereas today it is a little over four. We didn't want to place an enormous burden on the work population from years 2015 to 2030 by significantly raising payroll taxes to maintain the benefit level.

Am I mistaken? I recall debating and discussing that. How does that reasoning differ from your testimony?

Mr. BALL. Mr. Matsui, I want to make it clear that I do favor—Mr. Myers does not—but I do favor a buildup in the reserves. I am not as enthusiastic as Dr. Aaron, I think it is not primarily a Social Security issue. I think Social Security even with the higher costs later can still be handled on a pay as you go basis, or you can keep costs somewhat lower by building a reserve. Then you don't have to have quite as high a rate later on.

But the amount of a pay-as-you-go rate is not overwhelming. The reason I say that either way is feasible is that the 6.20 rate that is going in in 1990—only a slight increase from where we are today—will need to be increased out toward the end of the 75 year period in any event. It needs to be increased some. I was suggesting we might plan to increase it around 2030 and maintain this reserve. That would take a 1 percentage point increase in the rate.

Suppose if instead of that, you went on pay-as-you-go, taking into account all the points you are making about a higher cost. Even so, you don't reach more than a 1.8 percentage point increase in the rate. Actually, only a 1.5 percentage point increase if you allow for interest earnings on a contingency reserve. These are not overwhelming numbers for this kind of system. So I am just arguing that it is feasible.

I personally have a preference for building the reserve, largely for reasons unconnected with Social Security.

Mr. MATSUI. I am curious about that 1.8 percent increase up to $45,000, which comes to about $900 for the employee, $900 for the employer. I have read recent statistics that indicate that one-third of all money now going into the Federal Treasury comes from the payroll tax and the SSI tax.

In the year 2030, when we add that additional burden on the work force, 35 to 40 percent of all revenues into the Treasury will come from the payroll tax. I have a problem with that, if my numbers are roughly correct, because that is a very regressive tax. It is a very regressive tax, and it is a work force tax rather than capital tax. It taxes labor rather than capital, and it seems to me that is a real big burden we would be placing upon that second generation down the road, I guess. That is my concern.

I appreciate your view Mr. Ball, that you would prefer to keep a surplus. At the same time, I frankly think the whole issue of the surplus should be addressed. The surplus is a political problem—the unwillingness of the Congress and the President, to some extent the American public, to try to really recognize this as a problem, that the money really is earmarked for some other expenditure and we shouldn't be using it to pay for missiles, bombers and other types of programs.

I think if we address that issue, we don't have to worry about surplus.

Mr. MYERS. If I might add something, the view that you expressed is frequently said—namely, that the idea was to build up a large fund for the baby boomers. But that just was not the case.

While I believe the fund should be larger than it is now, I just do not believe it should be as large as it will get under present law. At the end of my testimony, I set forth a tax schedule that I would suggest, which is reducing the rate at present and for some years, and then raising it later as the costs go up.

But even with the reduced rate which I recommend, the fund would still continue to grow. Under the schedule which I suggest, the ultimate rate would be 1.5 percent higher each for the employer and employee than the rate which will go into effect in 1990.

I think that this is a perfectly feasible way to finance the system, as Mr. Ball says, and I think that it is much safer not to have these huge funds appear to be available to people in dollar bills that can be spent for benefits right away.

Mr. BALL. I think there may be some danger that it is beginning to look to the committee as if Mr. Myers and I are too much in agreement on this. It is not the case.

The last thing I would do would be to cut back on the tax. I wouldn't give up any tax that is already in present law with the kind of commitments that have been made against any new taxes. So I would certainly keep the tax.

Now, one point I was making is that I did want to leave maneuvering room for a later Congress. In the mid-1990's, it is conceivable to me that the Congress just might decide Medicare needs to get part of the contribution rate that is going for OASDI, and you could shift it over and that would move OASDI closer to pay-as-you-go. If this were done, I think it is still perfectly possible to work out pay-as-you-go for those two systems down the road. Both systems could be adequately funded that way, and it not ought to send the country into a big uproar about inadequate financing if you were to do that. That was my only point.

But I certainly wouldn't give up any tax.

Mr. AARON. Could I just say one thing? I think we all agree that the issue of whether the system is funded on a pay-as-you-go basis or reserve is built up is not primarily an issue of Social Security policy.

It is emphatically the case that that system can be soundly run on a pay-as-you-go basis or with reserve financing.

There are two real issues. One is how important is it to use whatever instruments are at hand to try to boost the national savings rate.

It may have been accidental, a bit of dumb luck, but Congress in 1983 proposed a tax schedule under which the baby-boom generation cohort-by-cohort will end up just about paying for the benefits they are going to enjoy under the Social Security system.

They did it right. You did it right. However that may have come about, it is to be welcomed.

The second issue is the one that Bob Myers raises, and I think it is very important. If there is a large reserve, how great is the risk that Congress will be unduly tempted to liberalize benefits more than is desirable. That is an important issue.

My suggestion for dealing with that problem would be to use the opportunity of adding to national savings through reserve accumulation as the occasion to adopt a policy for dealing with Social Security financing similar to that in private pensions. Specifically, tax rates should be set on a level basis for the entire projection period, whatever that period may be.

With respect to OASDI, we have done that. From 1990 current law calls for a flat tax rate estimated currently to cover the cost of benefits for the next 75 years.

If the system falls out of balance for any reason, I suggest that it would be prudent for the committee, for Congress, to proceed as private pension systems would do. That is, require an increase in the level of contributions to meet those costs, and do so immediately.

In that way if you vote the increase in benefits, you vote the increase in taxes that will be sufficient over your planning horizon period of time to pay for those benefits. In addition, if the reserves are kept out of the accounting for deficit reduction targets the annual excess of income over outgo is less visible, less obviously available for financing other operations of the Government.

So I think Mr. Myers has an important point but I think there is an alternative solution to the problem he raises while preserving the trust fund with an increase in savings.

Chairman Rostenkowski. Mr. Brown.

Mr. Brown. Thank you, Mr. Chairman.

I believe all three gentlemen have mentioned the potential options involving less reserves and eventually down the road a higher tax rate to cover it.

Mr. Ball, I think you referenced a 1.8 percent difference, the suggestion being if you didn't carry—obviously, a large reserve, and you would carry some reserves, but in the event you chose not to carry substantial reserves, that all it would take would be a 1.8 percent higher rate.

Something that might be helpful to me at least, and perhaps to others, would be to know what interest rate you are assuming in that calculation.

Mr. Myers. If I might answer that question, Mr. Brown, the actuarial calculations assume there will be a real interest rate of 2 percent. In other words, if there is 4 percent inflation, they assume the nominal interest rate will be 6 percent and, in fact, that is what figures are in essence in the intermediate cost estimates.

Mr. Brown. The 2 percent is generally in line with our recent history or with the source of the 2 percent real?

Mr. Myers. The 2 percent real interest rate is, I think, in line with history if you look back far enough. Currently, and in recent years, the real interest rate has been much larger than that. Now, you can get for instance, 8 or 9 percent now on good, grade A bonds, and inflation is running at 4 or 5 percent. So the real interest rate now is 4 or 5 percent.

However, at times in the 1970's, the real interest rate was much lower and in some years it was even negative. I think that most economists would agree that the real interest rate over the past history, looking back far enough, has been between 2 and 3 percent.

Mr. AARON. Could I add one point? If one goes to a truly pay-as-you-go system where the reserve is negligible, the interest rate you use is really not very important in the calculation.

Mr. BROWN. You are correct, but the interest rate is important in determining how much different the tax would have to be.

Mr. AARON. Between the full reserve system and the pay-as-you-go system, certainly.

Mr. BROWN. If you decline to answer I would certainly understand but if you use a 4 to 5 percent real interest rate in your assumption, do you have any feel for what the difference in the tax rate would be to provide a pay-as-you-go system?

Mr. MYERS. I believe that, if you had a 4 to 5 percent real interest rate—and you built up a fund and maintained it at the sort of magnitude contemplated in present law, the tax rate could be reduced by, perhaps, a quarter of a percent each on the employer and the employee, over what it would otherwise be if there were a 2 percent real interest rate.

Mr. BROWN. I was interested more in the comparison of how much different it would be in the future than in contrast to a pay-as-you-go system.

Mr. MYERS. In a pay-as-you-go system where you have only moderate interest receipts, the ultimate tax rate in the schedule that I have is 7.7 percent each. Ultimately, under a partial reserve system as you suggest—and with a 4 to 5 percent real interest rate—the rate could well be about 7 percent each.

Mr. BROWN. Thank you.

Thank you, Mr. Chairman.

I yield back.

Chairman ROSTENKOWSKI. Mr. Guarini will inquire.

Mr. GUARINI. Thank you, Mr. Chairman.

Thank you for your helpfulness once again.

Hank, in regard to the investments in private securities, which is very intriguing, the best business schools in our country take the moneys from Yale and Stanford and Harvard and put them into securities. They don't go the route of the safest investments. They take a gamble on America and America's future.

Are you suggesting that we can get a better return and still pump some capital into industrial expansion by using the Social Security funds in the manufacturing companies and probably homebuilding and things of that sort?

Mr. AARON. On this question I think it is the case that the three of us are in pretty substantial agreement. We favor a fairly conservative position with respect to the investment of the reserves.

If you take the rest of Government operations as given and Social Security runs an excess of income over outgo, Social Security will buy back Treasury securities from the public. This purchase releases funds to the public for investment in the whole range of private sector investments, housing, plant and equipment or for borrowing by other levels of Government to finance infrastructure.

One is buying trouble if one merges the important question of whether or not to accumulate Social Security reserves with another very important but highly divisive debate, concerning the degree to which explicit Federal investments should be used to pick industrial winners and losers and to try to promote particular sectors of private sector activity.

For that reason I personally would favor a continuation of the current method of investment and leave to capital markets the allocation among alternative investments of the additional savings generated by reserve accumulation. I understand the case to be made for a more aggressive stance and that a higher interest rate could be earned on those investments.

That could be a higher interest rate for the trust fund. It wouldn't necessarily be a higher rate of return for the economy as a whole.

Mr. GUARINI. Are you talking about buying stocks and bonds?

Mr. AARON. What I am suggesting is that the policy of putting reserves into special issues of the Treasury be continued. If reserve accumulation went a very long way and the stock of outstanding Treasury securities was depleted, I would move into agency issues, securities of the Federal National Mortgage Association, perhaps, but I would try very hard to avoid getting into direct investment in private stocks and bonds.

Mr. GUARINI. It could also lead to a lot of abuses I would assume?

Mr. AARON. I would be concerned about those but there is just no good economic reason for injecting them into the question of how to finance Social Security.

Mr. GUARINI. But you would operate for perhaps Government guaranteed securities such as home mortgage?

Mr. AARON. Government guaranteed securities, yes.

Mr. GUARINI. What about foreign investment? Stay away from it completely?

Mr. AARON. I would leave that to the private sector. That is extremely risky investment. There may be periods where high rates of return can be made, but I would try to link the method of financing of Social Security to the nature of the obligations that it incurs.

We do not incur foreign currency obligations.

Mr. GUARINI. Mr. Ball and Mr. Myers feel that way also?

Mr. BALL. I don't disagree with what Mr. Aaron said, but I would make this additional point. There has been some foreign experiences on this, and you might want, the staff might want to consult with Alicia Munnell at the Federal Reserve Bank of Boston who has been doing some work on what the Swedish Government has done and Canadian and Japanese.

Mr. GUARINI. What has their experience been?

Mr. BALL. I am not familiar enough with it to discuss it, sir.

Mr. GUARINI. But they have invested in private securities.

Mr. BALL. Sweden, particularly, has arrangements in which they do make investments outside of government, and they have a large fund build up in their public pension fund.

Mr. GUARINI. But it has worked successfully, has it not?

Mr. BALL. I don't know that I am in position to say that.

Mr. AARON. The Swedish culture is different. Labor or management negotiations are done on a national basis. Tax policy and wages are set simultaneously through negotiations.

Mr. GUARINI. Apples and oranges then.

Mr. AARON. It is not really a blueprint for policy in the United States.

Mr. GUARINI. Mr. Myers.

Mr. MYERS. I agree completely with Mr. Aaron on this. As far as the Canadian experience is concerned, I do not think that it can be called successful.

In Canada, the money has gone to the governments of each of the provinces, not at all to the private sector. The provinces, at least according to some critics, have really not spent the money as wisely as they might have, because they have had to borrow as much as was available. Thus, each province gets its share in proportion to the payroll taxes that are paid. In balance, it it certainly has not been considered successful. I think that Dr. Munnell, in a paper that I read, concurs in that.

Mr. GUARINI. Thank you, sir.

Chairman ROSTENKOWSKI. Mr. Coyne.

Mr. COYNE. Thank you, Mr. Chairman.

Dr. Aaron, what other trust funds are used in the fashion that the Social Security trust fund is, one that can be analogous to the softening of the deficit figure or giving the impression of a lower deficit?

Are there other trust funds that we have?

Mr. AARON. Most of the trust funds are now counted in the overall budget deficit. The issue, I think, that needs to be considered is whether they should be, and on what criterion, if any, should they be excluded.

The view that I think, I find persuasive is that in the event that the Government is making long-term commitments similar in nature to those that will be made under a private pension or welfare plan, that is health or pension benefits, benefits that are payable in the distant future, any excess of revenues over outgoes should not be considered as an offset against other expenditures of Government that are made for current purposes.

It is an argument related to the one for a capital budget, but I think it can be treated separately because this set of activities is not subject to the ambiguity and the controversy that surrounds debates about expenditure on defense.

In this case, we know perfectly well that Social Security obligations are being incurred for benefits up to a century ahead. Medicare benefits are being promised to people in the very distant future. The same is true for civil service and military retirement.

If we are building up reserves, we ought to try to do our best to make sure those reserves get translated into real capital that will increase in the capacity of the economy to produce when those benefits become due.

Mr. COYNE. Thank you.

Mr. Myers, what is the most current figure of the contribution made by those retiring now and going on Social Security. What was their lifetime contribution? Aside from the 15 percent figure that you cite? Is there a dollar figure?

I thought I heard at one time it was $1,400 that a potential Social Security recipient had contributed in a lifetime of contributions?

Mr. **Myers**. The total contributions which people have paid, if they were maximum wage earners for the entire life of the system, is $37,772. This is not taking into account interest. If you look at the situation of just how much has been paid in versus the value of the benefits, you get the 15 percent ratio.

You should take into account—from an analytical standpoint, rather than a tax standpoint—what contributions plus interest would purchase, because if people had not contributed, they would be getting interest elsewhere. Then, for people currently retiring, the purchased-annuity figure is nearer to 25 percent.

Of course, that proportion will increase gradually over the years.

Mr. **Coyne**. Someone who is retiring this year or next year is likely to have contributed in the neighborhood of about $35,000 over a lifetime at maximum income to the Social Security fund?

Mr. **Myers**. That is correct for employees.

A self-employed person pays in more, as you know, because of the higher self-employment rate. Appropriately, part of that should be considered as an employer tax.

Mr. **Coyne**. Thank you.

Chairman **Rostenkowski**. Mrs. Johnson.

Mrs. **Johnson**. Thank you, Mr. Chairman.

Thank you, gentlemen, for your discussion, particularly the issue of the plateau, which I heard with interest because, as many of my colleagues, understood that differently.

Mr. Ball, you mentioned that we could not sensibly consider reducing the reimbursement to hospitals. Could you enlarge on why you made that statement and on what basis you make that statement?

Mr. **Ball**. As you know, Mrs. Johnson, several reductions have already been made in the reimbursement of hospitals and Medicare is a large part of the income of hospitals. Many of them are now in the situation where they have, little choice but to shift any additional reduction in Medicare over to other payers or they would be in the position, many of them, of having to go out of business.

I was one who supported the idea of moving to a prospective rate. I think it has done good in reducing average stays in hospitals.

I think many of the things that Congress has done has operated to reduce the cost of Medicare. I just don't see in the hospital area anything new in the short term that could sensibly be done in reducing reimbursement. But I would be glad to look at any proposals that anyone has.

Mrs. **Johnson**. That has been my conclusion, too. I was interested in that you made that statement.

When you look at the projections for cost growth in Medicare over the next 4 years, it is about 50 percent of the current costs of the current program. What would it take in terms of a tax rate to put Medicare on a fiscally sound basis?

Mr. **Ball**. For—I think the issue becomes immediately—how long a period?

Mrs. **Johnson**. Over the next decade.

Mr. **Ball**. The hospital insurance part of Medicare actually builds a surplus under present law until about 1997. So it would take very little for 10 years. Now if you are going to have adequate financing over 25 years, you would have to increase the contribution rate as I remember it by 2015 at about 2.2 percent. That is a total increase of, about 1.5 percent of payroll, but that much wouldn't be needed until the end of the period.

Mrs. JOHNSON. Thank you very much.

Are you all in agreement that it would be wise, as I think it was Mr. Ball who mentioned that it might be reasonable to change the way, reverse the way we are planning to treat people who work until they are 70?

Mr. Myers.

Mr. MYERS. I am afraid that I do not agree. I think that what was done in 1983 was the right thing, except that it was not made effective soon enough.

I think that the so-called deferred retirement credit for people who work beyond age 65, the normal retirement age, should be the full 8 percent now that it is scheduled to be in the year 2009.

I believe that the retirement test, the way it works out now, is too great a disincentive for people to work. This is not just the case for only very high income people like doctors and lawyers.

Calculations that I have made show that people in more or less the average earnings ranges have $15,000 to $30,000 a year, are greatly discouraged from working by the way the retirement test operates now. If they received these larger deferred retirement, delayed retirement credits, this could encourage them to work longer because they are not being penalized for working.

Mr. AARON. Could I comment on that also?

I think the retirement test is, if anything, too liberal. There are conflicting objectives here.

On the one hand we want to encourage older people to work. On the other hand, when we liberalize the retirement test, a large part of the benefits goes to people with relatively high incomes. Not 100 percent to be sure, but a very large proportion do.

So the question is: to what extent does the evidence suggest labor supply among the elderly will increase if you liberalize the retirement test? A variety of studies have been done, some by my colleagues at Brookings.

The indications are that labor supply is remarkably insensitive to the retirement test. We get a little more labor supply, to be sure. We know the sign of the effect. But it is small. We also know the effect on benefit outlays. It is big.

A large amount of benefits goes disproportionately to high income people. It is how you trade off those two effects of liberalizing the test.

For myself, I make the trade off in the direction of not wanting to see any further liberalization in the retirement test.

Mrs. JOHNSON. Mr. Ball.

Mr. BALL. I would add simply that one important factor in my thinking was that in the next decade we are going to be in a labor market situation where employers, will want more older workers than they have in the past, perhaps through part-time work, maybe by rehiring.

I hate to see Social Security not get any financial benefit from that. Present law has in effect, given up the entire benefit that Social Security gets by withholding benefits between 65 and 70.

When you grant an actuarial equivalent increment for work between 65 and 70, it has the same cost as paying everyone at 65. This is an issue of how you look at the program.

If you think of it as an insurance program against a loss of earnings because of retirement, then there is no particular reason to compensate those people who are relatively lucky and are able to continue to work between 65 and 70. They have just not suffered the loss the system was designed to protect against.

If you look at it primarily as an annuity, then it is true that people who continue to work should get a benefit to compensate for the delay in taking a benefit.

Mr. MYERS. May I add one thing. For many years, I believed exactly as Mr. Ball does now, until I looked at the figures. I saw that people earning between $15,000 and $25,000 or $30,000 a year had very great disincentives to work, because they get very little net take-home income from working.

As to the very high-income people getting benefits if there were no retirement test, I do not like the idea of that either. At least partially offsetting is the fact that these benefits are subject to income tax. Particularly if this is coupled with what I believe should be done, and as my two colleagues believe—namely, to raise the income-taxable proportion to 85 percent—some of that windfall coming to the very high paid people who work between ages 65 and 70 would be removed.

Mrs. JOHNSON. Thank you. My time has expired. It is an issue that deserves watching.

Chairman ROSTENKOWSKI. Mr. Pickle will inquire.

Mr. PICKLE. I commend the panel for your testimony. You three gentlemen are the great old gentlemen of Social Security panels.

I may classify Mr. Aaron in with these other two elderly statesmen.

Mr. AARON. Mr. Myers was active on the Committee for Economic Security, which reported the year before I was born.

Mr. PICKLE. If we ever have a memorial built in this country for Social Security, it ought to honor you three fellows and Wilbur Cohen. You ought to be on the new Social Security Mount Rushmore where you have the four of your profiles carved in a mountain side.

I notice each one of you has maintained your gentlemanly differences over the years. You are just as far apart and as close as you always have been.

Mr. Aaron wants to keep everything pretty much like it is. Mr. Myers wants to reduce the contribution rate, which is predictable. Mr. Ball is kind of in the middle.

I wonder where Wilbur would be?

At any rate, your testimony is very helpful because it is a good analysis. I think, however, I will point up one difference with you.

Mr. Myers, you said, and I don't know whether you other gentlemen have taken the same position. You said neither the Congress nor the National Commission on Social Security Reform have intended to have the system build up a surplus and pay it back at a later date. I think we did intend that.

The record may not show a lot of discussion about the surplus. When that question was raised in our committee hearings in 1981, 1982, and 1983, generally we would say wouldn't it be wonderful to have to worry about a surplus.

We did, however, get a sort of cowboy drugstore statement from somebody. They said we were going to peak at about 2015 and 2220. Now we are ahead of the game.

I don't know why we are ahead on the collection of funds under the OASDI. Mr. Myers said we are ahead on HI because we are not paying out as much in utilization.

I don't know whether that is so or not. My hospital will be asking me what about that? Is that true? I can anticipate that question.

Overall, it is a good exercise that we are involved in. The new commission will be appointed this year, and I think their recommendation will be important. I hope we can get it early. I don't know if we are going to abide by it.

I think our biggest problem in the Congress now is just keeping everybody's grubby hands off the Social Security money that is in there. A lot of people think there is $100 billion of surplus in a Chicago Bank or somewhere. That is not so.

It is a paper faith and credit of the United States, and we have to live up to it. Now, it is kind of interesting to talk about is this really a debt reduction or is this really a surplus and does this apply for Gramm-Rudman-Hollings and not for the deficit or the debt.

I don't know what the answer is, but I do think we have got to find someway to keep the system operating as we planned it in 1983. I think we intended to build up a surplus.

I think we are a little surprised that it has built up as high as it has. But if we start letting others use it or if we do anything other than what we set out to do, I think we will be in trouble. That is going to be the test for it. I hope that we can pass this test.

I find your testimony interesting and exciting and predictable. So I don't think I have any questions for you other than to ask you for any comments you want to make, but I enjoy seeing you again.

Mr. BALL. Can I comment on this question of intent? I don't want to leave the committee with the impression that the National Commission and the Congress didn't realize that there would be surpluses. My comment was directed more to whether a deliberate decision had been made for the long run to depart from a general pay as you go system to an earnings reserve system.

We set the rates in the National Commission on a very pessimistic set up assumptions and recognized that if the economy performed better than we had said, a surplus would certainly be produced, an even larger one than the one we predicted. Alan Greenspan, I can tell you, was so concerned about making sure that we didn't get into trouble again in the short-term that he had the Department of Commerce run machine tapes on every set of assumptions you could have imagine up through the nineties. He practically filled my office with computer runs.

We knew there was a substantial surplus that was going to build in the nineties. We expected that even while the system was in trouble in 1981 and 1982. It was recognized that if you got to 1990, there would be a surplus even under the old law because of the fact that, relatively, the cost of Social Security would drop in the nineties.

Demography was favorable for Social Security in the nineties. That is because of the low birth rates in the great depression years. This is not a surprise. I didn't mean to give that impression.

Mr. PICKLE. We intended it for more than just the short term. We intended to build a surplus. To say that is kind of a surprise, it is just not accurate if that is what was intended, at least not from my standpoint.

Of course we had to build a surplus because we had to look in terms of 75 year actuarial balances. If we lose sight of that fact, we are going to be in trouble.

Mr. BALL. Because of cutbacks in the benefit level, moving the increase in the rate up to 1988 and then going to 67 as the first age for full benefits, all reduced the size of the program.

Mr. PICKLE. The surplus has to do with this economy. Raising the age of full retirement to 67, that has not been entered into the formula yet.

Mr. MYERS. It is always a great pleasure to work with you on Social Security matters. I want to make it clear that I believe in building up a fund, but only one of reasonable size to meet contingencies. I think that a fund of the size that is going to be built up under present law is too large.

Also, I think it is fair to say that, in 1983, there was not the intention, as some people say now, of building up a large fund just for the baby boomers and then using it up for them. The intent was to fund the system soundly over the 1980's and over the long range too.

To have a sound system, you do not have to have a sizable fund.

Chairman ROSTENKOWSKI. Will you yield?

Mr. PICKLE. Yes.

Chairman ROSTENKOWSKI. You know, I agree what the original intent was. But, you know where we have the problem. I have children that would sit at the dinner table with me and pooh-pooh me about whether or not there was going to be solvency in the system. They would criticize us, and say "why should I contribute if it isn't going to be there?"

The full faith and credit of the Government is involved in this system. Now, there is a different attitude on the part of at least my daughters, and they are saying, you know, I said, we will respond. It sometimes takes a crisis. Sometimes it takes dynamite, but we will respond.

I was just at the Press Club and asked a question about Social Security, about whether or not in the long run when the baby boomers are eligible, there will be funds—and my response was naturally that the solvency of that fund is to guarantee that legislators are going to seal it.

It is too much of a commitment for those of us that remember when it was enacted. I never would have called it a surplus. I would have called it a reserve. Because when you start calling it a surplus, somebody wants to put their merits on it.

But I think that that is the most credible thing, at least in the Social Security area, that this committee has done. We had a problem, we faced up to it, we solved the problem, and now we have the reserve. I just—I worry. You know, the idea of using this as part of the deficit, it is blue smoke in mirrors.

That is not the truth. You know, we play all kinds of games here. I just think that Social Security—and maybe I made a mistake today—but when we started talking about negotiations as to where we are going with respect to solving the problems of the deficit, I think everything is on the table.

The next question is, well, is Social Security on the table? Everything is on the table. If we are going to go to a negotiation, I just don't see how Dan Rostenknowski, if he is entitled to sit at the table, how somebody can say, I am sorry, but we can't touch revenues.

What the heck am I doing there? That is my job. I am a tax collector. If they are going to ask me to come to the table, they should assume everything we have jurisdiction over is there to be negotiated. It doesn't necessarily mean we are going to talk about Social Security, but it is there and it is there for negotiation.

I am sorry, Mr. Pickle. I am starting to sound like Mr. Pickle.

Mr. PICKLE. I don't, as I said, I don't have any questions. Your testimony is always highly valuable to us and has been extremely helpful. You three gentlemen and my old friend, Wilbur Cohen, have meant a great deal to this program. We thank you for it.

Mr. GUARINI. We got into this 65 years old because a long, long time ago, when Social Security was first started in Europe and Germany under Bismarck, I believe 65 was the arbitrary age. That was a long time ago and has no relevance to the temp of our times today.

We want to keep more people working, not make them feel like they are on the waste pile. They are not psyched out thinking their life is over and they are in their last twilight years. There is a lot of life left in these old-timers.

We have a Supreme Court where three members are over 80 years of age and they are still virtually running the Court and the country. I am wondering whether or not we should give a little more thought to have a schedule that is progressive based on actuarial findings to allow people to retire more than 70.

In other words, any time that they want to cut out of the system, they just get a little bit more according to the actuarial tables. People can work up to 75 or 80 if they want to and feel useful to themselves and to their society. We don't give any thought to that. We limit ourselves. Bismarck picked 62 or 68. Do you have any impression on that?

Mr. MYERS. First, I am sorry to say I have to point out that Bismarck selected age 70. That was the age in the original German system.

Mr. GUARINI. The point is even more valid.

Mr. MYERS. One of the favorite pastimes of my old friend, Wilbur Cohen, and me was to write letters to newspapers that repeated this story about Bismarck and age 65. Since Wilbur departed from the scene, I have that responsibility solely on my shoulders. I have almost a form letter that I send out when I see that statement.

To answer your question, I think that you have a very good point that for those who do go on working beyond age 70, there is no incentive to not claim benefits.

Mr. **Guarini**. They are paying taxes, Social Security, paying into the system.

Mr. **Myers**. After age 70, you continue to pay taxes every year even though a benefit is being received. If such earnings are used in a benefit recomputation, then you get a larger benefit. If it was an option, it will not cost the system to provide that if you do not want benefits at age 70, you can take them later with an actuarial-equivalent increase.

If somebody worked until age 75, and this were done, it would not cost the system anything.

Mr. **Guarini**. The Government benefits by these people being in the revenue stream paying more income tax.

Mr. **Myers**. It makes a much better benefit design to have larger benefits when you retire, instead of having smaller benefits plus your earnings, and then have your income fall off when you stop working and have only the benefit.

Mr. **Guarini**. Are you going to do anything about it?

Mr. **Myers**. This could be done very easily under present law. It would not create any notch babies or anything like that.

Mr. **Guarini**. Thank you, sir.

I have one question for Dr. Aaron.

Doctor, you suggested that Social Security should be placed off budget, that such a move may have the effect really of encouraging additional deficit reduction efforts. Would, in your opinion, such a move by itself have any impact on economic growth?

Mr. **Aaron**. Writing up a set of accounts in different form has no effect on anything except on the accounts themselves. It has no necessary political or economic effect.

How to account for the budget deficit is a matter of political craft. It is a matter of judgment as to what way in presenting data to yourselves and to the American public is most likely to produce sound economic policy over an extended period of time.

I am worried, as I think each of the other panelists is, that continuing to merge the annual excess of revenues over outgoes in Social Security and of the other trust fund programs with deficits in the rest of Government conceals the fact that these deficits are even larger than we acknowledge in our official statistics. This practice obscures the magnitude of the problem that we face.

I think that it will be easier for the public to understand the fiscal tasks before it if we segregate and treat separately the accumulation of reserves to meet future obligation for retirement, pension and health benefits.

For that reason, I do favor separating Social Security from the rest of the budget. I think there is a legitimate basis for concern about whether if it were done tomorrow afternoon it would help or hinder the already formidably difficult tasks of meeting the Gramm-Rudman targets.

Therefore, I agree with Mr. Ball that it might well be desirable to plan to do that at some time a few years hence when those targets are near to actually being met.

But in setting the long run for where we want to go, it seems to me the correct way to set our budget target is to keep Social Security, Medicare, civil service and military retirement out and to try to aim for whatever target we want with respect to the rest of Government operations.

I would go for balance. If somebody told me a 1 percent of GNP deficit was suitable, that would be fine, too. We are a long way even from such a somewhat relaxed target. So the answer, in short, at the end of all is this: Yes, move it out.

Chairman **Rostenkowski**. I don't argue with that. I feel pretty comfortable doing that myself, only to highlight the fact that we are in big trouble. The only way you get people's attention is to tell them that if the deficit is $140 billion, take Social Security out of it and it is $240 billion or $270 billion.

Sequestration does not frighten me. As I understand it, this afternoon, this evening's budget will suggest that we take $5 billion in the health area, Medicare and that we have to cut $5 billion.

Whether my colleagues want to take credit for it or not on this side of the aisle and on this committee, we pretty much helped design Gramm-Rudman. When we did that, the social safety net came into being. So if I to raise the revenues that are suggested by Members other than in the administration, if I have got to cut $5 billion in Medicare, if Social Security is not involved, and it isn't under the social safety net, then the obligation of this committee is minimized when you compare $5 billion cut suggested by the administration and only a $2 billion cut in sequestration.

So I just hope that those who are at the rudder with the administration's ship of state don't think that they frighten us with respect to sequestration because it is a lesser hit here in this committee than it is over in the Armed Services Committee.

I want to thank you all for joining us this afternoon.

[Whereupon, at 4 p.m., the committee was adjourned, subject to the call of the Chair.]

THE BUDGET DEFICIT, THE STATE OF THE U.S. ECONOMY, AND FEDERAL BUDGET POLICY FOR FISCAL YEAR 1990 AND BEYOND

WEDNESDAY, MARCH 7, 1989

House of Representatives,
Committee on Ways and Means,
Washington, D.C.

The committee met, pursuant to notice, at 10 a.m., in room 1100, Longworth House Office Building, Hon. Dan Rostenkowski (chairman of the committee) presiding.

Chairman Rostenkowski. Will our members and guests please find seats.

The committee will come to order.

For the next few days we will be hearing testimony from members of the administration as an initial step toward understanding their budget package.

This morning we will be hearing from Richard Darman, Director of the Office of Management and Budget.

As chairman of the Committee on Ways and Means, I would like to express my optimism about the budget process. If the Congress and the administration work together, I believe we can produce a credible multi-year budget package that will solve the Government's most pressing problem by reducing the Nation's budget deficit.

While undertaking this process we must maintain a healthy economy and avoid sending the nation mixed signals from Washington.

In order to achieve this, the leaders at both ends of Pennsylvania Avenue need to work together. We must work together using realistic economic assumptions and producing real reductions in deficit, not blue smoke and mirrors. No corporate planner would assume interest rates at 3 percent in 1994. Even in the short run assuming interest rates for calendar year 1989 of 7.4 percent or interest rates of 6.5 percent by the end of this year are too optimistic.

In my judgement, if we produced a credible deficit reduction package of $20 billion in year 1, and some $30 to $40 billion in the out-years, there would be a modest decline in interest rates. But no miracle reductions of 5 to 6 percentage points.

I have made no secret of my belief that a deficit reduction package must include both spending reductions and revenue increases.

I do not want to raise taxes, but I cannot see how we can achieve significant amount of deficit reduction on the spending side only.

Furthermore, I agree with the President that there is a pent-up demand for new spending to build a kinder and gentler America.

Unless we can get deficit reduction behind us it will be difficult to consider spending more money, and I think we must keep in mind that new programs, however worthwhile, must be paid for.

I hope that the President and his staff will deal with budget issues justly, fairly, and honestly. We have to use realistic economic assumptions and make practical recommendations. We will only postpone and exacerbate the pain by masking the true problem with blue smoke and mirrors.

Mr. Darman, you have presented us with a very clever package. There are optimistic economic assumptions, asset sales, large domestic cuts, and no defense cuts. In particular there are huge Medicare cuts of $5 billion next year and $53 billion over the next 5 years. Members on both sides of the aisle have indicated an unwillingness to go anywhere near that level of cuts in the Medicare program.

Two of your revenue raising suggestions—the Medicare tax for State and local employees, and the repeal of the trigger on excise taxes for Airport and Airway Trust Fund—simply do not have the votes in this committee to pass. Furthermore, according to your estimates, your capital gains tax cut picks up $9 billion over the next 5 years, but loses $24 billion, according to the Joint Committee estimates.

We cannot stand the risk, in my opinion, of losing that much revenue. We are willing to work with you, Mr. Darman, but frankly, I would prefer to let sequestration happen before passing your budget as it presently stands.

Mr. Darman, I know that you have testified before this committee before, and we have always enjoyed the exchanges. In my opinion, Mr. Darman, you have a formidable task in front of you. I wish you well. I certainly hope that we can come to some understanding, and I realize how hard the bullet is.

I think that both the administration and this committee ought to measure up to the task of biting it.

Mr. Schulze.

Mr. SCHULZE. Thank you, Mr. Chairman.

Mr. Chairman, let me begin by welcoming Mr. Darman on his first appearance before the Ways and Means Committee as the new Director of OMB.

We have been looking forward to your testimony and the testimony of the other administration witnesses.

Earlier this year the committee heard from a number of distinguished economists. They all agreed on one point: The Federal deficit is the number one domestic problem facing the country. We have an opportunity—and it may be a brief one—to get control of the situation and tackle our fiscal problems. Otherwise we may soon find economic events controlling us.

I congratulate President Bush and you, Mr. Darman, and the rest of the President's economic team for putting your solution on the table. You have met the Gramm-Rudman targets, faced the savings and loan crisis, and presented a new domestic agenda for the 1990's, yet you have kept your promise of no new taxes.

I hope we will soon be joining you at the table to work on a bipartisan solution to the deficit. We need to start early and need to move quickly with budget negotiations. If we do not, the public, financial markets, and our trading partners may lose face in us.

The President has indicated his desire for immediate negotiations. I endorse that idea, and I look forward to working with you, Mr. Darman, and other members of the administration this year.

Thank you, Mr. Chairman.

Chairman Rostenkowski. Any further comments? If not, we will welcome Richard, and good luck.

STATEMENT OF HON. RICHARD G. DARMAN, DIRECTOR, OFFICE OF MANAGEMENT AND BUDGET

Mr. Darman. Thank you, Mr. Chairman. It is nice to be back. May I ask that my statement——

Chairman Rostenkowski. Your entire statement will be included in the record.

Mr. Darman. Thank you, and then I would, with your permission, read a portion of the statement, but not the entire statement, in order to save the committee's time.

Chairman Rostenkowski, distinguished members of the House Committee on Ways and Means, please let me thank you very much for this opportunity to discuss President Bush's proposals.

I appear before you in what, I would hope, you will find to be a constructive spirit seeking to advance our common objective: the prompt enactment of a responsible budget program that can meet the Gramm-Rudman-Hollings deficit reduction targets on schedule.

With your permission, I would first outline the President's overall approach to the budget and then note the very important set of proposals that directly involve the Committee on Ways and Means—before responding to your questions.

In seeking to meet the Gramm-Rudman-Hollings objectives on time, the President has suggested that a responsible set of proposals must pass several basic tests. First, they must attend to fundamental obligations—such as the payment of interest, the protection of national security, and the funding of Social Security.

Second, within the limits of scarce resources they must address special obligations to the poor, as through means tested entitlement programs and incentives for child care; and to future generations as through environmental protection, they must begin to remedy problems inherited from the past, the scourge of drugs, the crisis in the savings and loan sector, the failure to invest adequately in the modernization and clean-up of nuclear weapons production, and they must advance priorities for future American growth and competitiveness as through measures to encourage sound investment in research, education, enterprise, and longer term productivity.

Third, they must do all of these things while also restoring fiscal balance—meeting the Gramm-Rudman-Hollings targets without raising taxes and without threatening what is now America's longest period of sustained peacetime economic growth.

The President's proposals were presented, as you know, on February 9, in a 193-page volume entitled "Building a Better America." His proposals, I believe, meet the several tests that I've noted. In addition to the 193 page volume we have since provided the Congress with over 4,000 pages of supplementary detail. These submissions are noted at appendix A, and are contrasted in that appendix with submissions of prior Presidents.

With these various submissions, and through informal consultation as well, I think it is fair to say that we have submitted more data and explanation than any new President has done at a comparable stage of his Presidency in the modern budgeting era.

The initial presentation of the President's proposals stirred a bit of attention for its effort to change a local habit of mind. That habit has a curious wonderland quality. It is described by a phrase that is unknown to most of the country but common among Washington budgeteers: current services baseline budgeting.

I will not burden you with our general critique of current services budgeting, for I know you are now familiar with it. But let me please make clear that the critique is not confined to discretionary programs.

Some of the most curious cases involve entitlements. Consider Medicare, for example. President Bush is proposing to increase Medicare by about $8 billion in fiscal year 1990 relative to fiscal year 1989—from $84.5 to $92.5 billion. Advocates of current services budgeting claim that that proposed increase of $8 billion should be called a cut of $5 billion. This, I would contend, defies the common use of language; but worse, it may be phony.

The curious current services baseline not only increases Medicare expenditures for inflation, utilization, and growth in the beneficiary population, all of which is arguably legitimate, it also conveniently assumes that several current provisions will all disappear—Medicare's capital cost reimbursement at 85 percent, the provisions for clinical lab reimbursements, and supplementary medical insurance premiums payments with the current 25 percent premium floor.

That is, current provisions are not used in calculating current services. If these current provisions were to disappear, as assumed under current services, Medicare's expenditures would be almost $2 billion higher than if the provisions were to remain as they are today.

Conversely, if the current reimbursement and premium provisions would stay as they are, Medicare expenditures would be almost $2 billion lower than the artificial current service's projection.

So, with this curious form of current services accounting, if the Congress simply decides to extend the current Medicare provisions, Medicare will be said to be cut by almost $2 billion. That is, if the program increases, not by our recommended $8 billion, but by over $11 billion—with today's provisions simply extended—a fictitious cut of almost $2 billion will be claimed. I would contend that that is fundamentally misleading.

There have been too many compromises announcing heroic savings measured against ethereal, misleading constructs. It should be little wonder that fictional savings have failed to materialize. The fiction should not continue. The deficit is rising. It is time to do something real.

But whatever one's views on the wonderland budgeteers' habit of mind, there is another issue of perspective that is, I think, even more important.

Whether we budget from last year's levels, a zero-base, current services, or any other reference point, it is essential that we give greater attention to investment in the future. As a matter of analysis, that means we must attend to the relative emphasis given to new spending for current transfers and consumption versus new spending for future gains in productive power and the quality of life.

Our freedom for spending initiatives is limited. We are constrained by problems from the past and obligations to the present. But within the limits set by these constraints, President Bush's proposed initiatives tilt toward the future. They emphasize investment in research and development, investment in education and child care and development, investment in the protection of the environment, investment in combatting drug abuse, and investment in the creation of incentives for new economic opportunity.

The list of seemingly worthy claims always exceeds available resources. It is only limited by human imagination. The necessity for choice is inescapable.

For a summary of President Bush's priority choices I would refer you to appendices B and C. But in making choices it is important to note, the voters of the present are well-represented, the citizens of the future are less so. At the margin of choice, the citizens of the future must depend on the wisdom and generosity of a present generation that is willing to invest in the future.

But the question is rightly asked, "How do we finance all of this?" And the answer is straightforward. The first and most important contributor is economic growth. With a growing economy and no change in current law, revenues are projected to increase from $978.6 billion in fiscal year 1989 to $1.06 trillion in fiscal year 1990. That is an increase of more than $80 billion. The Congressional Budget Office estimates even higher revenues than the administration. And that is no small amount of money, it is more than the GNP of 137 countries.

But even so, with the claims made by deficit reduction, fundamental and special obligations, problems from the past, and priorities for initiative and investment, there is also need for restraint on the growth of the remainder of the budget. The need is mitigated somewhat by certain mandatory programs that naturally decline. These are identified as Appendix D.

It is mitigated further by our ability to make sensible reforms in programs that would otherwise be an excessive drain on limited resources. Our suggestions here are at appendix E.

Still, in order to meet the Gramm-Rudman-Hollings targets, there remains the need to freeze the remainder of the budget as follows: freeze all retirement COLA's for Federal civilian and military employees for 1 year; freeze defense budget authority at zero real growth for 1 year; and freeze residual nondefense spending—other than in areas of priority initiatives—at 1989 levels for 1 year. The effects of this in dollars is summarized in appendix F.

With these steps, it is possible to fund necessary and desirable program growth while also reducing the budget deficit below the targets of $100 billion in fiscal year 1990 and zero in fiscal year 1993.

The net effect of all of these proposals would increase total spending by 1.2 percent. Within this total, defense would increase by 0.7 percent. The Defense Department itself, I might note, would increase by less than that, about 0.4 percent. All nondefense discretionary programs would increase, by contrast, by 3.3 percent. And all other mandatory programs, including those that naturally decline, would increase by 1.1 percent. Since revenues are projected to increase by almost 9 percent, the deficit can be reduced substantially, even as all of these major expenditure areas grow.

In implementing the President's approach to the budget—or any other serious approach—the Ways and Means Committee, quite obviously, has a fundamentally important role. The committee must address proposals in three broad areas: special entitlement obligations, receipts, and structural reforms of existing programs.

Since you are all very familiar with what is before the Ways and Means Committee, I will simply refer you to the list that follows in the prepared testimony, touching on everything from Social Security to various revenue proposals, the child care proposals, enterprise zones, long-term development incentives, and so on—all of which are before this committee.

That said, I should emphasize, Mr. Chairman, that we do not pretend to have either all of the answers or the only acceptable set of answers. We have offered a set of proposals we believe have merit. We look forward to learning of other proposals, and to discussing them on the merits. We mean to be cooperative, we welcome the spirit that you reflected in your introductory comments.

But this, of course, on our part, is not enough. We cannot unilaterally produce a budget. We in the executive branch cannot legislate. We can offer and exchange views, but in the end we must come to an executive/legislative agreement.

To that end, as a matter of practical reality, we must negotiate. The only question is whether we do so promptly or late.

From our perspective, serious negotiation would best begin sooner rather than later. Although the real economy remains strong, interest rates are rising, and markets seem less firm than one would wish. Our Government is divided between the two great parties. That division is viewed by some as a formula for stalemate, and stalemate is fraught with risk. The risks are economic. If we do not act responsibly and in a timely fashion, rising interest rates may cause the economy to founder, creating significant human costs in the process.

And the risks are political. If we do not act responsibly and in a timely fashion, public cynicism about our collective capacity to govern may only deepen.

But it need not be so. The President has said that this is not time to settle for business as usual. Our job, as we see it, is to do our utmost to make divided Government work. We are prepared to work in good faith and in a bipartisan spirit day and night—if that is what it takes—to reach a constructive agreement. And in that spirit, I would be pleased to try to respond to your questions, Mr. Chairman and members of the committee.

May I thank you again for inviting me to appear before you today.

Thank you.

[The statement of Hon. Richard G. Darman follows:]

EXECUTIVE OFFICE OF THE PRESIDENT
OFFICE OF MANAGEMENT AND BUDGET
WASHINGTON, D.C. 20503

INTRODUCTORY STATEMENT:
THE PRESIDENT'S BUDGET PROPOSALS

PRESENTED BEFORE

THE HOUSE COMMITTEE ON WAYS AND MEANS

BY

RICHARD DARMAN

DIRECTOR, OFFICE OF MANAGEMENT AND BUDGET

MARCH 7, 1989

Chairman Rostenkowski, Congressman Archer, and distinguished members of the House Committee on Ways and Means, please let me thank you very much for this opportunity to discuss President Bush's budget proposals. I appear before you in what I hope you will find to be a constructive spirit, seeking to advance our common objective: the prompt enactment of a responsible budget program that can meet the Gramm-Rudman-Hollings deficit reduction targets, on schedule.

With your permission, I would first outline the President's overall approach to the budget and then note the very important set of proposals that directly involve the Committee on Ways and Means -- before responding to your questions. I would also ask that the set of Appendices that accompany this testimony, and to which I may refer, be included in the record.

Building A Better America: The President's Proposals

In seeking to meet the Gramm-Rudman-Hollings objective, on time, the President has suggested that a responsible set of budget proposals must pass several basic tests:

- They must attend to fundamental obligations -- such as the payment of interest, the protection of national security, and the funding of social security.
- Within the limits of scarce resources:
    - they must address special obligations (to the poor, as through means-tested entitlement programs and incentives for child care; and to future generations, as through environmental protection);
    - they must begin to remedy problems inherited from the past: the scourge of drugs; the crisis in the savings and loan sector; the failure to invest adequately in the modernization and clean-up of nuclear weapons production; and
    - they must advance priorities for future American growth and competitiveness (as through measures to encourage sound investment in research, education, enterprise, and longer-term productivity).

- They must do all these things while also restoring fiscal balance -- meeting the Gramm-Rudman-Hollings targets, without raising taxes, and without threatening what is now America's longest period of sustained peacetime economic growth.

The President's proposals were presented to the Congress on February 9 in a 193-page volume titled, Building A Better America. His proposals meet the several tests I have noted.

In addition to the 193-page volume, we have since provided the Congress with over 4000 pages of supplementary detail. These submissions are noted at Appendix A -- and are contrasted with submissions of prior Presidents.

With these various submissions, and through informal consultation as well, I think it fair to say that we have submitted more data and explanation than any new President has done at a comparable stage of his Presidency in the modern budgeting era.

Changing A Habit of Mind: From Wonderland Budgeting to Common Sense Budgeting

The initial presentation of the President's proposals stirred a bit of attention for its effort to change a local habit of mind. That habit has a curious Wonderland quality. It is described by a phrase that is unknown to most of the country, but common among Washington budgeteers: "current services baseline" budgeting. I will not burden you with our general critique of current services budgeting -- for I know you are now familiar with it. But let me please make clear that the critique is not confined to discretionary programs.

Some of the most curious cases involve entitlements. Consider Medicare, for example. President Bush is proposing to increase Medicare by about $8 billion in FY'90 relative to FY'89 -- from $84.5 billion to $92.5 billion. Advocates of current services budgeting claim that that proposed increase of $8 billion should be called a "cut" of $5 billion. This defies common uses of language. But worse: it is phony.

The curious "current services" baseline not only increases Medicare expenditures for inflation, utilization, and growth in the beneficiary population. It also conveniently assumes that several current provisions will all disappear -- for Medicare's capital cost reimbursement (at 85%), clinical lab reimbursements, and supplementary medical insurance premium payments (25% premium floor). That is, current provisions are not used in calculating "current services"!

If these current provisions were to disappear, as assumed under "current services," Medicare's expenditures would be almost $2 billion higher than if the provisions were to remain as they are today. Conversely, if the current reimbursement and premium provisions were to stay as they are, Medicare expenditures would be almost $2 billion lower than the artificial "current services" projection.

So, with this curious form of "current services" accounting, if the Congress simply decides to extend the current Medicare provisions, Medicare will be said to be "cut" by almost $2 billion. That is, if the program increases not by our recommended $8 billion, but by over $11 billion -- with today's provisions simply extended--- a fictitious "cut" of almost $2 billion will be claimed. I would contend that this is fundamentally misleading.

There have been too many compromises announcing heroic "savings" measured against ethereal, misleading constructs. It should be little wonder that fictional "savings" have failed to materialize.

The fiction should not continue. The deficit is rising. It's time to do something real.

Shifting Perspective: From Preoccupation with the Present to Investment in the Future

Whatever one's views on the Wonderland budgeteers' habit of mind, there is another issue of perspective that is, I think, even more important. Whether we budget from last year's levels, a "zero base," "current services," or any other reference point, it is essential that we give greater attention to investment in the future. As a matter of analysis, that means we must attend to the relative emphasis given to new spending for current transfers and consumption versus new spending for future gains in productive power and the quality of life.

Our freedom for spending initiatives is limited. We are constrained by problems from the past and obligations to the present. But within the limits set by these constraints, President Bush's proposed initiatives tilt toward the future.

They emphasize:

- Investment in research and development -- with major funding increases for basic science, biomedical research, space, and the superconducting super-collider; as well as proposed improvements in the Research and Experimentation (R&E) expense allocation rules and the R&E tax credit.

- Investment in education and child development -- with proposals for a new merit schools program; a new National Science Scholars program; increased funding for historically black colleges, magnet schools, Head Start, and experimentation and innovation; as well as a new refundable tax credit of up to $1000 for each child under 4 with a working parent in low-income families, and a related proposal to make the existing child care credit refundable; along with a restoration and doubling of the adoption expense tax deduction.

- Investment in the protection of the environment -- with proposals for clean coal technology development, a new Clean Air Act, postponement of OCS drilling off of California and Florida; as well as tougher regulation and enforcement for hazardous waste clean-up, ocean dumping, and protection of wetlands.

- Investment in combatting drug abuse -- with proposals that would increase outlays by almost $1 billion for fiscal year 1990.

- Investment in the creation of incentives for new economic opportunity -- with proposals for a new longer-term capital gains initiative, and provision for up to 70 enterprise zones.

The list of seemingly worthy claims always exceeds available resources. It is limited only by human imagination. The necessity for choice is inescapable. (For a summary of President Bush's priority choices, please see Appendices B and C). But in making choices, it is important to note: the voters of the present are well-represented; the citizens of the future are less so. At the margin of choice, the citizens of the future must depend upon the wisdom and generosity of a present generation that is willing to invest in the future.

But "How Do We Pay?"
Growth, Priorities, and Balanced Restraint

But, the question is rightly asked, "How do we finance all this?" The answer is straightforward.

The first and most important contributor is economic growth. With a growing economy -- and no change in current law -- revenues are projected to increase from $978.6 billion in fiscal year 1989 to $1.060 trillion. That's an increase of more than $80 billion. (The Congressional Budget Office estimates even higher revenues than the Administration.) That is no small amount of money: it is more than the GNP of 137 countries.

Even so, with the claims made by deficit reduction, fundamental and special obligations, problems from the past, and priorities for initiative and investment, there is also need for restraint on the growth of the remainder of the budget. This need is mitigated somewhat by certain mandatory programs that naturally decline. (See Appendix D.) It is mitigated further by our ability to make sensible reforms in programs that would otherwise be an excessive drain on limited resources. (See Appendix E.) Still, in order to meet the Gramm-Rudman-Hollings targets, there remains a need to freeze the remainder of the budget as follows: freeze all retirement COLAs for federal civilian and military employees for one year; freeze defense budget authority at zero real growth for one year; and freeze residual non-defense spending (other than in areas of priority initiatives) at 1989 levels for one year. (See Appendix F.)

With these steps, it is possible to fund necessary and desirable program growth while also reducing the budget deficit below the targets of $100 billion in FY 1990 and zero in FY 1993. (See Appendix I.)

The net effect of all these proposals is to increase total spending by 1.2%. Within this total, defense would increase by 0.7%. All non-defense discretionary programs would increase by 3.3%. And all other mandatory programs (including those that naturally decline) would increase by 1.1%. Since revenues are projected to increase by almost 9%, the deficit can be reduced substantially -- even as all these major expenditure areas grow.

The Importance of Ways and Means

In implementing the President's approach to the Budget -- or any other serious approach -- the Ways and Means Committee, quite obviously, has a fundamentally important role. The Committee must address proposals in three broad areas:

-- special entitlement obligations;

-- receipts; and

-- structural reforms of existing programs.

With respect to the first of these categories -- special entitlement obligations -- President Bush has proposed the following for programs within the jurisdiction of the Ways and Means Committee:

- Full funding of Social Security benefit payments: In fiscal year 1990, nearly 40 million beneficiaries would receive an estimated $244 billion in Social Security benefits.

- Full funding of Supplemental Security Income benefits: There will be an estimated 4.5 million SSI beneficiaries at the start of FY '90; and benefit payments for the year total an estimated $11 billion.

- Full funding of AFDC benefit payments: 3.8 million families will receive an average of $384 per month for each family -- totaling an estimated $9.6 billion in Federal outlays (the rest State and local); in addition, AFDC Emergency Assistance payments totaling an estimated $275 million would be paid to families experiencing emergency needs in FY '90.

- Full funding of benefit payments for workers eligible under the Trade Adjustment Assistance Program -- $210 million for FY '90.

- $14.3 billion in payments for all those estimated to qualify for unemployment insurance compensation in FY '90.

With respect to the second category -- receipts -- President Bush's proposals include the following (in addition to those previously advanced by President Reagan):

- Adoption: The President proposes to restore and double (to $3000 per child) the federal income tax deduction for special needs children. (This is in addition to $138 million provided for adoption-related discretionary programs and Social Security benefits.)

- Child Care: As noted above, the President proposes a new, refundable child care tax credit for young children in low-income families with a working parent; and he proposes to make the existing child care tax credit refundable. The rationale for refundability is straightforward: many low-income families have little or no federal income tax liability, and therefore cannot otherwise claim the full credit. The rationale for using the tax system for this purpose is both economic and philosophical. This approach is more efficient, and it provides parents with more choice.

- Energy Resource Development: The President proposes a 10% credit for the first $10 million (and five percent of the balance) of annual expenses for exploratory intangible drilling costs (effective January 1, 1990); elimination of 80% of minimum tax preference items from exploratory intangible drilling costs in excess of amortization and income allowances; and a 10% R&D credit for tertiary enhanced recovery. These proposals focus on exploratory activity in an attempt better to address the fact that domestic exploratory drilling has fallen sharply, and oil imports have been rising.

- Enterprise Zones: The President proposes to stimulate new economic activity in depressed areas by providing selected employment and investment tax preferences for activity in up to 70 enterprise zones.

- Long-term Investment: The President seeks to reduce tendencies toward short-term speculative activity and to increase incentives for longer-term investment and entrepreneurship. To do so, he proposes a reduction in the capital gains tax rate for financial assets held for 3 years or more (after phase-in). The proposal would not apply to collectibles and depreciable property -- and it would reduce the gains tax rate to zero for families with incomes of $20,000 or below.

- Telephone Excise Tax: The present 3% telephone excise tax has been scheduled to expire periodically since 1959. It has again been scheduled to expire in 1990. Congress has consistently extended it in the past. To fail to do so would reduce federal receipts by approximately $1.6 billion in FY '91, $2.6 billion in FY '92, and $2.8 billion FY '93.

With resepct to the third important area of Ways and Means responsiblity -- structural reform of existing programs -- Medicare is the principal focus of interest. The administration's proposals can be conceived in two categories.

- Proposals that would merely extend current reimbursement and premium provisions: In total, these proposals would "save" over $1.8 billion in FY '90 relative to "current services."

- Proposals that would further restrain the growth in payments to providers: These would save an additional $2.4 billion under Part A and $0.8 billion under Part B of Medicare.

The total of such savings (real and artificial) would be over $5 billion. Although the specifics of the proposals differ in some areas, the Administration's proposals achieve roughly the same amount of savings as would be achieved by adopting the comparable set of proposals identified by the Congressional Budget Office. Both the CBO set and the Administration's set reject deep cuts that would have significant adverse effect on beneficiaries.

The Need to Negotiate: "We Cannot Settle for Business as Usual"

That said, I should emphasize that we do not pretend to have either all the answers or the only acceptable set of answers for Medicare or for the budget as a whole. We have offered a set of proposals that we believe have merit. We look forward to learning of other proposals -- and to discussing them on the merits.

We mean to be cooperative.

But this, of course, is not enough. We cannot unilaterally produce a budget. We in the Executive Branch cannot legislate. We can offer and exchange views. But in the end, we must come to an Executive-Legislative agreement. To that end -- as a matter of practical reality -- we must negotiate. The only question is whether we do so promptly or late.

From our perspective, serious negotiation would best begin sooner rather than later. Although the real economy remains strong, interest rates are rising and markets seem less firm than one would wish. Our government is divided between the two great parties. That division is viewed by some as a formula for stalemate -- and stalemate is fraught with risk.

The risks are economic: if we do not act responsibly, and in a timely fashion, rising interest rates may cause the economy to founder -- creating significant human costs in the process. And the risks are political: if we do not act responsibly, and in a timely fashion, public cynicism about our collective capacity to govern may only deepen.

But it need not be so. The President has said that this is not time to settle for business as usual. Our job, as we see it, is to do our utmost to make divided government work. We are prepared to work in good faith, in a bi-partisan spirit -- day and night, if that's what it takes -- to reach a constructive agreement.

In that spirit, I would be pleased to try to respond to your questions. May I thank you again for inviting me to appear before you today.

Attachments: Appendices A through N

Appendix A

INITIAL PRESENTATIONS OF BUDGET DATA BY NEW PRESIDENTIAL ADMINISTRATIONS—1969-1989

During the past 20 years, the Presidency has changed hands five times: January 1969, when President Nixon succeeded President Johnson; August 1974, when President Ford succeeded President Nixon; January 1977, when President Carter succeeded President Ford; January 1981, when President Reagan succeeded President Carter; and January 1989, when President Bush succeeded President Reagan.

Because a President who leaves office following a November general election presents his last budget request to Congress in January, shortly before the inauguration of his successor, the new President is given the opportunity to transmit an amended budget to Congress. He is under no legal obligation to do so. Of the four Presidents listed above who took office in January, each transmitted a revised budget to Congress. However, the extent of the revisions and the amount of detail provided has varied substantially—as suggested by the following summary.

President	*Submission*	*Scope*	*Date*
Nixon:	12-page memorandum.	Estimates for 1969 and 1970; reestimate of receipts postponed; no out-years; no current services.	April 15, 1969
Carter:	101-page compilation of Message and tables.	Estimates for 1977 and 1978; no comparison with or use of current services baseline; disclaimer: "The 1978 budget is essentially still President Ford's budget, with only such limited revisions as my Administration has had time to make."	February 22, 1977
Reagan:	"Program for Economic Recovery."	1981–86; program changes—but with line for "budget savings to be presented subsequently."	February 18, 1981
	"1982 Budget Revisions."	BA/outlays by function, 1980–82 (compared with Carter, not with current services)—but with "additional savings to be proposed."	March 21, 1981
	"1982 Budget Revisions, Additional Details or Budget Savings."	Proposed program changes (not all) with BA/outlays, 1981–86.	April 7, 1981

President	*Submission*	*Scope*	*Date*
Bush:	"Remarks by the President to the Joint Session of Congress," 9 pages, with supplement entitled *Building a Better America*, 193 pages.	1989–93; proposed complete budget, including specific program initiatives (with outlays by function), reforms, natural declines, and special obligations.	February 9, 1989
	"General Explanation of the President's Budget Proposals Affecting Receipts," 55 pages.	In-depth discussion of 11 specific governmental receipt proposals, 1989–93.	February 9, 1989
	Supplementary data package provided to the Budget Committees, 28 pages.	Bridge from Reagan to Bush G-R-H baseline.	February 16, 1989
		FY 1990 Non-Defense Discretionary Residual Options, by Function/Subfunction.	
		Economic and technical changes since January, 1989–1993.	
		Adjustments for Credit Reform Component of Reagan Budget, 1989–1993.	
		Asset Sales Component of Reagan vs. Bush Budgets, 1989–1993.	
		Bush Structural Reforms vs. Current Services, 1989–1993.	
		National Defense Budget Levels, 1988–1993.	
	Supplementary data package provided to the Budget Committees, 491 pages.		February 18, 1989
	192 pages	FY 1990 Bush Budget Priority Programs by FY 90 BBA Category/Function/Subfunction/Account.	
	110 pages	FY 1990 Mandatory Residual Options by Function/Subfunction/Account.	
	4 pages	FY 1990 Defense Residual Options by Function/Subfunction/Account.	
	185 pages	FY 1990 Non-Defense Discretionary Residual Options by Function/Subfunction/Account.	
	"Testimony Before the House and Senate Budget Committees," 8 pages.	Explanations of both the President's priorities and how to pay for them.	February 21 and 22, 1989
	Appendices to the Testimony, 14 pages	Initial Presentations of Budget Data by New Presidential Administration—1969–1989.	February 21 and 22, 1989
		Areas of Priority Initiative Spending.	
		Receipts Proposals and Priority Receipts Intiatives.	
		Mandatory Programs That Naturally Decline Under Current Law.	
		Structural Reforms in Mandatory Programs.	
		Applying the Residual Freeze.	
		Flows Associated With Financial Sector Reform.	

President	*Submission*	*Scope*	*Date*
Bush (Cont.):		Rescissions and Supplementals for Fiscal Year 1989.	
		Receipts, Outlays and Projected Deficits.	
		President Bush's Budget Presented in Budget Summit Framework.	
	Supplementary data package presented to the Appropriation Committees, 568 pages.		February 23, 1989
	188 pages	FY 1990 Bush Budget Priority Programs by Appropriation Subcommittee/Agency/Account.	
	380 pages	FY 1990 Residual Options by Appropriation Subcommittee/Agency/Account.	
	Supplementary data package presented to the Appropriations and Budget Committees and CBO, 1,298 pages.		March 3, 1989
	608 pages	FY 1990 Bush Priorities and Options for Residual Accounts by BBA (Bipartisan Budget Agreement) Category/Function/Subfunction/Account.	
	690 pages	FY 1990 Bush Priorities and Options for Residual Accounts by Function/Agency/Bureau/Account.	
	Supplementary data package presented to the Appropriations and Budget Committees and CBO, 1,676 pages.		March 6, 1989
	489 pages	FY 1990 February Current Services by Function/Agency/Bureau/Account.	
	565 pages	FY 1990 Bush Budget by Function/Subfunction/Account, 1989–1993.	
	622 pages	FY 1990 Bush Budget by BBA Category/Function/Subfunction/Account, 1989–1993.	

Appendix B

PRESIDENT BUSH'S BUDGET—AREAS OF PRIORITY INITIATIVE SPENDING

(In millions of dollars)

	1989		1990		Total Increase	
	BA	Outlays	BA	Outlays	BA	Outlays
Investing in R&D and Long-Term Productive Capacity						
Basic research	2,707	2,613	3,068	2,905	361	292
National Aeronautics and Space Administration	10,898	10,596	13,274	12,597	2,376	2,001
Superconducting Super Collider	100	100	250	206	150	106
National Institutes of Health	6,543	6,250	6,777	6,600	234	350
Census	655	672	1,497	1,587	842	915
Investing in People						
Department of Education	17,280	16,336	17,874	17,104	594	768
Ending the Scourge of Drugs						
Drug abuse	5,331	4,569	5,966	5,543	635	974
Prisons and other Justice Department programs	4,025	3,979	4,460	4,297	435	318
Meeting Special Obligations: A Kinder, Gentler America [1]						
Land and water conservation	206	240	206	244	—	4
Acid rain	190	92	710	120	520	28
Homeless:						
Fully fund the McKinney Act	466	408	746	496	280	88
Non-McKinney homeless initiative	—	—	50	25	50	25
Other assistance for homeless	125	92	211	124	86	32
Head Start	1,235	1,202	1,485	1,351	250	149
YES—Youth Engaged in Service	—	—	25	21	25	21
HIV/AIDS	1,287	1,217	1,600	1,377	313	160
Medicaid	34,301	34,301	37,616	37,616	3,315	3,315
Attending to Problems of the Past [2]						
Atomic energy clean up and modernization	2,588	2,536	3,663	3,237	1,075	701
Federal Aviation Administration	6,591	5,733	7,743	6,639	1,152	906
Securing a More Peaceful World						
International affairs	17,598	16,660	19,314	17,677	1,716	1,017
Total (excluding double counts)	111,631	107,239	125,974	119,234	14,343	11,995

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[1] Social security and means-tested entitlement programs are fully funded, but they are not reflected in this table.

[2] The comprehensive reform package (involving public and private resources) for FSLIC is described in Section III B–1 of *Building a Better America*.

Appendix C

PRESIDENT BUSH'S BUDGET—RECEIPTS PROPOSALS

(In millions of dollars)

	1990	1991	1992	1993
GOVERNMENTAL RECEIPTS				
Double and restore adoption deduction	–*	–3	–3	–3
Eliminate Superfund tax differentials	0	0	0	0
Enhance long-term investment incentives	4,800	4,900	3,500	2,200
Establish credit for intangible drilling	–200	–300	–300	–400
Establish enterprise zones	–150	–200	–300	–400
Establish user fee on IRS telephone services	—	48	48	48
Expand and extend the child care credit:				
Establish a new tax credit and revise existing credit—receipt effect	–5	–46	–48	–52
Make existing and proposed credit refundable—outlay effect	–182	–1,847	–2,163	–2,430
Subtotal, child care	–187	–1,893	–2,211	–2,482
Extend Customs processing fee	—	157	167	177
Extend HI coverage to State and local employees[1]	1.831	1,915	1,916	1,906
Extend R&E credit	–387	–688	–963	–1,150
Extend telephone excise tax[1,2]	—	1,586	2,606	2,804
Increase NRC and FEMA fees	341	352	353	360
Increase IRS enforcement	317	630	653	668
Let abandoned mine fee expire	—	—	–44	–269
Make miscellaneous changes in receipts[3]	–23	–10	–2	8
Provide credit for tertiary enhanced recovery	–*	–*	–*	–*
Reduce customs fees to be GATT competitive	–197	–243	–291	–310
Repeal airport and airway trigger[1]	892	1,553	1,678	1,806
Revise AMT for exploratory drilling by independents	–100	–100	–100	–100
Revise oil and gas depletion rules	–39	–49	–45	–47

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[1] Net of income tax offsets.

[2] Assumes extending the current tax of 3 percent.

[3] Includes initiation of Federal marine fishing licenses and fees, an increase in the D.C. employer contribution to the civil service retirement system, the receipt impact of the Federal pay raise, and other small items outside the jurisdiction of the Ways and Means Committee.

PRESIDENT BUSH'S BUDGET—RECEIPTS PROPOSALS—Continued

(In millions of dollars)

	1990	1991	1992	1993
Revise R&E allocation rules	–1,699	–749	–814	–887
Revise unemployment tax on Amtrak	–5	–2	3	4
Receipt effect	6,147	9,602	8,950	7,355
Outlay effect	–953	–2,698	–3,099	–3,423
Total, Bush proposals	5,194	6,904	5,851	3,932
USER FEES				
Loan guarantee fees:				
Small Business Administration	94	94	94	94
Commodity Credit Corporation export loans	30	30	30	30
Rural Electrification Administration	14	27	41	55
Farmers Home Administration	3	30	49	62
Subtotal, loan guarantee fees	141	181	214	241
Federal and federally-sponsored enterprise fees:				
Government-sponsored enterprises (GSEs):				
Freddie Mac	25	101	236	321
Fannie Mae	30	120	274	371
Sallie Mae	4	19	45	63
Connie Lee[4]	n.a.	n.a.	n.a.	n.a.
Subtotal, GSE fees	59	240	555	755
Government National Mortgage Association (Ginnie Mae) fees	0	23	75	128
Subtotal, GSE and Ginnie Mae	59	263	630	883
Total, credit fees	200	444	844	1,124
Service fees:				
Coast Guard: decal for recreational and commercial boaters	180	180	180	180
Food and Drug Administration	87	97	101	103
Animal and plant health inspection	68	68	68	68
Veterans medical care	24	26	27	29
Corps of Engineers recreational facilities	20	21	23	24
U.S. Travel and Tourism Administration	11	13	15	15

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[4] Data not available; only relatively small amounts anticipated.

PRESIDENT BUSH'S BUDGET—RECEIPTS PROPOSALS—Continued

(In millions of dollars)

	1990	1991	1992	1993
USER FEES—Continued:				
Service fees—continued:				
Railroad safety	9	15	31	31
Forest service	8	8	8	8
National Oceanic and Atmospheric: maps, charts, and data sales	7	7	7	10
Agriculture marketing service	4	4	4	4
Small Business Administration	3	3	3	3
Total, service fees	421	442	467	474
Total, all user fees	620	886	1,311	1,598
OTHER OFFSETTING COLLECTIONS				
Outer Continental Shelf receipts	10	0	−136	0
Arctic National Wildlife Refuge	2,101	1	1	1,301
Chlorofluorocarbon production rights	400	1,350	550	625
Unassigned spectrum, FCC	2,252	1,126	0	0
Subtotal, other collections	4,763	2,477	415	1,926
Total receipts and collections	10,577	10,267	7,577	7,456

Appendix D

PRESIDENT BUSH'S BUDGET—MANDATORY PROGRAMS THAT NATURALLY DECLINE UNDER CURRENT LAW

(In millions of dollars)

	Current Services		
	1989	1990	Decrease
International affairs:			
Development and humanitarian aid, offsetting receipts	–480	–505	–25
Conduct of foreign affairs	15	9	–6
International financial, excluding Export-Import Bank	–68	–81	–13
Energy:			
Tennessee Valley Authority	540	300	–240
Nuclear waste disposal fund	–526	–538	–12
Nonconventional fuel	159	4	–155
Agriculture:			
Commodity Credit Corporation	13,036	12,645	–391
Crop insurance fund	1,049	356	–693
Commerce and housing credit:			
Ginnie Mae mortgage-backed securities	–210	–313	–103
Federal Housing Administration, excluding asset sales	1,537	586	–951
Federal Deposit Insurance Corporation	3,807	–1,324	–5,131
National Credit Union Administration	–169	–195	–26
Science and technology	189	152	–37
Transportation:			
Panama Canal fund	34	–4	–38
Education, training, employment, and social services:			
Guaranteed student loans	3,602	3,282	–320
Income security:			
Means-tested:			
Aid to Puerto Rico	908	825	–83
Supplemental Security Income	11,389	11,038	–351
Family support	9,847	9,581	–266
Earned Income Tax Credit	3,849	3,841	–8
Other:			
Disabled coal miners	1,529	1,505	–24
Pension Benefit Guaranty Corporation	–301	–415	–114
Federal employee life insurance	–782	–842	–60
Low-rent public housing loans	788	503	–285
Veterans benefits and services:			
GI bill and readjustment benefits	620	451	–169
Third-party reimbursement	–138	–304	–166
Loan guaranty fund, excluding fees and asset sales	1,758	1,582	–176
Administration of justice:			
Customs fee	–637	–771	–134
General government:			
OPM revolving fund	–11	–25	–14
Mineral and land payments	547	511	–36
Total	51,881	41,854	–10,027

Appendix E

PRESIDENT BUSH'S BUDGET—STRUCTURAL REFORMS IN MANDATORY PROGRAMS

(Outlays in billions of dollars)

	1989	1990	Dollar Change
Medicare	84.5	92.5	+8.0
Federal Employees Health Benefits	1.9	1.6	−0.3
Farm Support Payments	13.9	10.7	−3.2
Power Marketing Reforms	−0.6	−1.5	−0.9
Lump-Sum Federal Retirement Benefits	1.6	0.6	−1.0
Other [1]	2.9	2.0	−0.9
Total	104.2	105.9	+1.6

	1990	1991	1992	1993
Savings from Current Law:				
Medicare	−5.0	−8.1	−10.7	−13.6
Federal Employees Health Benefits	−1.2	−1.5	−1.8	−2.0
Farm Support Payments	−1.9	−1.8	−2.4	−2.4
Power Marketing Reforms	−0.9	−0.6	−0.5	−0.5
Lump-Sum Federal Retirement Benefits	−2.1	−2.2	−2.4	−2.5
Other [1]	−0.6	−0.2	−0.2	−0.4
Total	−11.8	−14.4	−18.0	−21.3

[1] Other includes a 1990 adjustment for electronic transfers of food stamp cash balances, reform of guaranteed student loans, and extensions of a 1 percent VA loan fee and VA asset sales.

Appendix F

PRESIDENT BUSH'S BUDGET—APPLYING THE RESIDUAL FREEZE

(Outlays in billions of dollars)

	1989	1990	Dollar Change	Percent Change
Freeze residual non-defense spending at 1989 levels ("nominal freeze") [1]	136.0	136.0	—	—
Freeze Federal retirement COLAs	51.2	52.7	1.5	2.9
Freeze defense budget authority at zero real growth [2]	289.8	291.2	1.4	0.5
Total	477.0	479.9	2.9	0.6

[1] This nominal freeze applies to all programs except social security and other social insurance program benefits, means-tested entitlement benefits, programs subject to structural reforms, mandatory programs that decline naturally, initiatives (including S&L reform) specified in the Bush budget, net interest, undistributed offsetting receipts, and asset sales.

[2] The defense freeze is applied to budget authority for subfunction 051. Numbers presented above are the associated outlays.

Appendix G

PRESIDENT BUSH'S BUDGET—FLOWS ASSOCIATED WITH FINANCIAL SECTOR REFORM

(In billions of dollars)

	1989	1990	1991	1992	1993	1989–1999
FSLIC and RTC Account						
Disbursements:						
Old cases and other expenses:						
Administrative and miscellaneous	0.3	0.3	0.3	0.3	0.3	2.8
Notes issued	9.7	—	—	—	—	9.7
Interest on notes outstanding	1.4	1.5	1.1	0.9	0.8	9.2
Repayment of notes issued prior to 1987	—	—	0.2	—	0.2	0.5
Assistance payments	5.2	4.4	3.8	4.2	3.4	28.8
Liquidations	1.0	—	—	—	—	1.0
Total, old cases and other expenses	17.7	6.2	5.5	5.4	4.7	52.2
New cases:						
Assisted mergers	5.0	12.5	8.5	1.2	1.8	44.0
Liquidations	5.0	12.5	8.5	1.2	1.8	30.0
Total, new cases	10.0	25.0	17.0	2.4	3.6	74.0
Total disbursements	27.7	31.2	22.5	7.8	8.3	126.2
Collections (–):						
FICO proceeds (CEBA) (–)	–3.8	–3.3	—	—	—	–7.1
New REFCORP proceeds (–)	–10.0	–25.0	–15.0	—	—	–50.0
Insurance premiums:						
Before deductions (–)	–2.1	–2.3	–2.7	–2.9	–3.1	–31.6
Deduct (+):						
FICO (CEBA) interest	0.6	0.9	1.0	1.0	1.0	10.7
Secondary reserve credit	0.1	0.1	0.1	0.1	0.3	0.7
Defense new bond principal	—	1.7	1.7	—	—	3.3
Net premium income (–)	–1.4	0.4	0.1	–1.8	–1.7	–16.9
Proceeds from receivers and corporate-held assets (old cases) (–)	–1.4	–1.4	–1.2	–1.0	–1.4	–9.7
Income on investment balances (–)	–0.1	—	—	—	–0.1	–1.1
Other collections (–)	–0.4	–0.4	–0.4	–0.3	–0.3	–3.5
Total collections	–17.0	–29.8	–16.5	–[illegible].2	–3.6	–88.3
FSLIC/RTC net outlays	10.7	1.4	6.0	4.6	4.7	37.9
Repayments of notes issued after 1986	0.4	0.3	0.1	—	1.1	19.2
Balance of FSLIC notes outstanding (end-of-year)	19.2	18.9	18.6	18.5	17.3	—
FSLIC/RTC cash/investment end-of-year balances (9/30/88 = $1.9 billion):						
Balance for cases	0.6	0.5	0.5	0.5	0.5	0.5
Balance for new fund	—	—	—	1.0	2.1	8.8
Summary of Accounts Affected						
FSLIC net outlays	10.7	1.4	6.0	4.6	4.7	37.9
Treasury contribution to REFCORP interest	0.5	1.4	1.6	0.9	0.8	22.0
Additional FDIC collections	—	–0.8	–1.6	–1.7	–1.8	–19.9
Total budget outlays	11.1	1.9	6.0	3.8	3.7	39.9

Appendix H

PRESIDENT BUSH'S BUDGET—RESCISSIONS AND SUPPLEMENTALS FOR FISCAL YEAR 1989[1]

(In billions of dollars)

	Budget authority	Outlays	Revenues	Deficit
Rescissions[2]	*	*	—	*
Mandatory supplementals:				
Guaranteed student loans (pending from January)	—	0.3	—	0.3
Guaranteed student loans (change for economics)	—	0.4	—	0.4
VA compensation, pensions, and burial benefits	0.7	0.7	—	0.7
VA readjustment benefits	*	*	—	*
VA loan guaranty	0.3	0.3	—	0.3
TAA training and benefits	0.1	0.1	—	0.1
Other Supplementals:[3]				
Forest Service firefighting	0.3	—	—	—
Student financial assistance	*	—	—	—
Foster care/adoption assistance[4]	0.4	0.4	—	0.4
Justice (FSLIC)	*	*	—	*
Total supplementals	1.8	2.2	—	2.2
Other changes:				
Administrative actions:				
Advanced deficiency payments	—	0.8	—	0.8
Strategic petroleum reserve	—	0.1	—	0.1
Substantive legislation:				
Guaranteed student loans	—	–*	—	–*
Capital gains tax reduction	—	—	0.7	–0.7
FSLIC	—	0.4	—	0.4
Amtrak unemployment insurance tax	—	—	–*	–*
Treaty ratification:				
Compact of free association	0.2	0.2	—	0.2
Related debt service	*	*	—	*
Grand total	2.6	3.7	0.7	3.0

* Less than $50 million.

[1] As of February 9, 1989.

[2] President Reagan's rescission proposals are withdrawn except for those that offset proposed spending increases.

[3] Excludes supplementals that are entirely offsetting.

[4] Foster care/adoption assistance figures were not included in published numbers. All other supplementals were included.

Appendix I

PRESIDENT BUSH'S BUDGET—RECEIPTS, OUTLAYS, AND PROJECTED DEFICITS

(Assuming Prompt Implementation of the President's Proposals)

(In billions of dollars)

	1989	1990	1991	1992	1993
Receipts	979.3	1,065.6	1,147.6	1,218.6	1,286.6
Outlays, excluding asset sales	1,149.9	1,160.4	1,211.8	1,249.2	1,284.1
Deficit, excluding asset sales	170.7	94.8	64.2	30.6	–2.5
G-R-H targets	136.0	100.0	64.0	28.0	0.0
Deficit, including asset sales[1]	163.7	91.1	61.9	26.8	–3.8

[1] The 1989 amount is $0.4 billion higher than the February 9 estimate to adjust for all supplementals—including foster care/adoption assistance, which was omitted in the February 9 calculation.

Appendix J

PRESIDENT BUSH'S BUDGET—PRESENTED IN BUDGET SUMMIT FRAMEWORK

(In billions of dollars)

	1989 February Estimate	1990 Bush Budget	1990 Bush vs. 1989 Est.
Defense:			
Priority:			
Department of Defense:			
Budget Authority	290.2	299.3	+9.1
Outlays	289.8	291.2	+1.4
Atomic energy cleanup:			
Budget Authority	2.6	3.7	+1.1
Outlays	2.5	3.2	+0.7
Other:			
Budget Authority	6.0	6.0	—
Outlays	5.9	5.9	—
Total:			
Budget Authority	298.8	309.0	+10.2
Outlays	298.3	300.4	+2.1
International Discretionary:			
Priority:			
Budget Authority	17.6	19.3	+1.7
Outlays	16.7	17.7	+1.0
Freeze:			
Budget Authority:			
Option 1 (RR method)	0.7	0.1	–0.6
Option 2 (nominal outlays [a])	0.7	0.7	—
Outlays	–0.3	–0.3	—
Total:			
Budget Authority:			
Option 1 (RR method)	18.3	19.4	+1.1
Option 2 (nominal outlays [a])	18.3	20.0	+1.7
Outlays	16.3	17.3	+1.0
Domestic Discretionary:			
Priority:			
Budget Authority	47.5	55.5	+8.0
Outlays	56.9	62.1	+5.2
Freeze:			
Budget Authority:			
Option 1 (RR method)	95.9	91.3	–4.6
Option 2 (nominal outlays [a])	95.9	94.1	–1.8
Outlays	120.2	120.2	—
Total:			
Budget Authority:			
Option 1 (RR method)	143.4	146.8	+3.5
Option 2 (nominal outlays [a])	143.4	149.5	+6.2
Outlays	177.1	182.4	+5.2

PRESIDENT BUSH'S BUDGET—PRESENTED IN BUDGET SUMMIT FRAMEWORK—Continued

(In billions of dollars)

	1989 February Estimate	1990 Bush Budget	1990 Bush vs. 1989 Est.
Mandatory:			
Naturally Declining:			
Outlays	51.9	41.9	−10.0
Structural Reform: [b]			
Outlays	104.2	105.9	+1.6
Freeze:			
Outlays	10.2	10.2	—
Other:			
Outlays	377.1	387.3	+10.2
Total (excluding double counts):			
Outlays	526.4	529.1	+2.7
Asset Sales and Prepayments:			
Budget Authority	−0.9	−1.4	−0.5
Outlays	−6.9	−3.6	+3.3
User Fees and Other Collections:			
Budget Authority	—	−5.2	−5.2
Outlays	—	−5.2	−5.2
Interest:			
Budget Authority	168.8	173.3	+4.5
Outlays	168.8	173.3	+4.5
Undistributed Offsetting Receipts:			
Budget Authority	−36.9	−36.9	—
Outlays	−36.9	−36.9	—
Total:			
Outlays	1,143.0	1,156.8	+13.8
Receipts	979.3	1,065.6	+86.4
Deficit	163.7	91.1	−72.6

[a] Freeze option 2 is a nominal outlay freeze at the account level.

[b] Includes portions of GSL and farm support payments counted in "Naturally Declining," and FEHB and PMA reform counted in "Domestic Discretionary—Priority."

Appendix K

PRESIDENT BUSH'S BUDGET—PRIORITY SPENDING PROGRAMS WITHIN THE JURISDICTION OF THE COMMITTEE ON WAYS AND MEANS

(Outlays in billions of dollars)

	1989	1990	1991	1992	1993
Program: [1]					
Social Security (OASDI) benefits	230.0	244.3	259.9	274.5	288.2
SSI benefits	11.4	11.0	12.7	13.3	13.9
Unemployment insurance benefits	13.8	14.3	14.4	15.3	16.1
AFDC benefits and child support	9.8	9.6	9.6	10.0	10.8
Trade adjustment Assistance benefits	0.3	0.2	0.2	0.2	0.2
Medicare benefits [2]	84.6	92.5	104.3	118.0	129.2
Adoption Initiative in Foster Care account [3]	0.1	0.1	0.1	0.1	0.2

[1] The estimates in this table are for benefits only. Administrative costs are in the "residual freeze" category of the Bush Budget.

[2] Medicare change from current services — −6.0 −8.1 −10.7 −13.6

[3] Excludes 1989 supplemental of $0.4 billion.

Appendix L

PRESIDENT BUSH'S BUDGET—SPENDING PROPOSALS IN THE "RESIDUAL FREEZE" CATEGORY WITHIN THE JURISDICTION OF THE COMMITTEE ON WAYS AND MEANS

(Outlays in millions of dollars)

	1989 Budget February Estimate	1990 Freeze Option 1 RR Method	1990 Freeze Option 2 Nominal Freeze	1990 Freeze Option 3 (To Be Negotiated)
Foster care	928	787	928	
TAA training	80	49	80	
Administrative expenses:				
Social Security (OASDI)	2,342	2,420	2,342	
SSI	1,087	1,111	1,087	
Medicare	2,269	2,428	2,269	
AFDC (State administered)	1,475	1,476	1,475	
Unemployment insurance	1,675	1,744	1,675	

Appendix M

PRESIDENT BUSH'S BUDGET—TOTAL RECEIPTS

(In billions of dollars)

	1989	1990	1991	1992	1993
Individual and corporation income taxes	534.5	589.9	642.9	689.6	728.1
Social insurance taxes and contributions:					
Employment taxes and contributions:					
Off-budget	267.5	289.2	312.8	332.1	354.8
On-budget	69.3	75.6	80.9	85.6	91.0
Subtotal, employment taxes	336.8	364.8	393.7	417.7	445.8
Unemployment insurance receipts	23.1	22.4	20.9	19.9	19.8
Contributions for other insurance and retirement	4.7	4.7	4.8	4.8	4.7
Subtotal, social insurance taxes and contributions:					
Off-budget	267.5	289.2	312.8	332.1	354.8
On-budget	97.2	102.7	106.6	110.2	115.6
Total	364.7	391.9	419.4	442.3	470.3
Excise taxes	34.0	35.3	35.8	36.6	37.4
Estate and gift taxes	7.8	8.1	8.3	8.3	8.3
Customs duties and fees	16.3	17.4	18.6	19.5	20.2
Miscellaneous receipts:					
Federal reserve deposits	18.5	19.2	18.9	18.3	18.4
Other miscellaneous	3.4	3.7	3.8	4.0	3.8
Subtotal, miscellaneous	21.9	23.0	22.7	22.3	22.2
Receipts:					
On-budget	711.8	776.4	834.8	886.5	931.8
Off-budget	267.5	289.2	312.8	332.1	354.8
Total	979.3	1,065.6	1,147.6	1,218.6	1,286.6

Appendix N

PRESIDENT BUSH'S BUDGET—MEDICARE: PROPOSED "SAVINGS" RELATIVE TO "CURRENT SERVICES" [1]

(Outlays in millions of dollars, net of offsetting receipts)

	1990	1991	1992	1993
Medicare Current Services	99,977	115,238	131,611	145,702
EXTENSIONS OF CURRENT LAW				
Capital at 85% of Cost Allocation	930	1,190	1,300	1,420
25% Floor on Part B Premiums	714	1,757	2,812	4,409
Clinical Lab Limits	190	330	410	480
Continue Current Law Extensions	1,834	3,277	4,522	6,309
FURTHER RESTRAINT ON COST GROWTH				
Part A Proposals:				
Capital at 75% of Cost Allocation	620	780	880	940
Reduce Indirect Medical Education to 4.05%	1,020	1,290	1,410	1,540
Reduce Part A Graduate Medical Education Overhead	120	130	135	140
Update PPS Rates by Hospital Inflation minus 1.5%	625	800	875	955
Other Part A Proposals	10	21	23	25
Subtotal, Part A Proposals	2,395	3,021	3,323	3,600
Part B Proposals:				
Freeze Non-Primary Physician Prevailing Charges	375	960	1,640	2,085
Reduce Radiology, Anesthesia, and Surgical Payments by 8%	250	430	510	570
Reduce Payments for Overpriced Procedures	100	180	210	240
Target Physician Reforms	70	155	210	255
Limit Outpatient Department Reimbursementsc	0	220	520	780
Reform Durable Medical Equipent Payments	160	240	290	330
Eliminate Home Kidney Dialysis Loophole	50	100	150	230
Reduce Part B Graduate Medical Education Overhead	30	30	35	40
Impact on Part B Premiums	–295	–612	–876	–1,076
Subtotal, Part B Reductions	739	1,703	2,689	3,454
Interaction—Catastrophic Health Insurance	90	160	200	250
Total Proposals	5,058	8,161	10,734	13,613

NOTE: The Budget also reproposes one Part A revenue proposal. Under current law, all State and local employees hired after March 31, 1986 are covered by HI. This proposal would extend coverage to all State and local employees and generates revenues of $2 billion in FY 1990.

[1] HCFA actuary estimates.

Chairman ROSTENKOWSKI. Thank you, Mr. Darman.

Mr. Darman, I am always impressed with the testimony that you give before this committee, and as usual, you have done a marvelous job of at least confusing this member.

The Gramm-Rudman-Hollings law, spelled out the budget baseline, and on the Hill we, in particular this committee, have worked with the CBO baselines for 10 years or more.

I would like to put the record straight for a few simple facts with respect to fiscal year 1990. Using Gramm-Rudman-Hollings budget baseline, the size of the defense cut is zero.

Do you agree with that—using the Gramm-Rudman-Hollings budget baseline?

Mr. DARMAN. It should be very close to zero. Let me just double-check. There might be a slight difference between what we have got, but it should be extremely close to zero.

Actually our outlays are slightly less than what they would be under Gramm-Rudman-Hollings—it is a slight cut of a billion and a little relative to the Gramm-Rudman-Hollings baseline, but it is a technical reason that they are so, having to do with differences in the outlay estimates.

Chairman ROSTENKOWSKI. Using, again, the Gramm-Rudman-Hollings budget baseline, the size of the Medicare cuts are about $5 billion, is that right?

Mr. DARMAN. That is right.

Chairman ROSTENKOWSKI. The size of other entitlement cuts is approximately $8 billion?

Mr. DARMAN. I do not have that number off-hand because we do not budget against current services.

Chairman ROSTENKOWSKI. I see.

Well, not including you spending on high priority programs, the domestic discretionary cuts are approximately $7 billion.

Mr. Darman, when I total all of these cuts, the defense budget has not been cut at all, and there are domestic cuts of $20 billion.

I have made my observation known in the Oval Office in your presence with the President, and I am still of the opinion that these cuts are not politically realistic, and I do not really know how many members of this committee—even if you were just going to narrow it down to the $5 billion in Medicare cuts—are going to support that, and you well know, and I think that we have worked together, I want to see us accomplish what is necessary for us to get our economic house in order.

I, for one, am willing to take a look at the hard line and the cuts that are necessary, but I just do not see, first of all, us passing the budget recommended by the President in this committee and nor do I see it happening on the floor of the House.

Now, once again, Mr. Darman, I think that a revenue component is going to have to be a part of the ingredient, otherwise I see a bipartisan refusal to accept this budget. I know that we are going to try very hard here to come to some resolution when we get what I am sure you are going to negotiate with the Budget Committee a budget resolution.

But I just think the administration ought to think very seriously about its stand in cement on revenues.

I have no further questions.

Mr. Gibbons.

Mr. GIBBONS. Mr. Darman, one of the things that worries me—we are obviously spending a lot of money that we do not need to spend, particularly in Medicare because we do not have enough people out there enforcing the law.

For instance, in my area in Florida where we have a high percentage of Medicare patients, we only have one inspector general, or perhaps two, now for a population of about 3.5 to 4 million people. Now not all of those are on Medicare, but that covers all of the HEW-type programs.

The door is wide open unless we are willing to station some people down there and all over the country to enforce these laws. These laws are not self-executing, and there have been a lot of fast-buck artists moving into this area. Not all of them are medical personnel. Some of them are selling equipment, some are selling all kinds of voodoo economics and health care.

I do not see where we can get any of these savings until we are willing to hire some people to go out and enforce the existing law.

What is your response to that?

Mr. DARMAN. Congressman Gibbons, I think that increased enforcement may be desirable, but my own opinion is that we have some savings under the heading Medicare that we could agree upon that are program savings that should be in addition to what everyone can get from improved enforcement. I have tried to suggest in my prepared statement that of the $5 billion that the chairman has mentioned and others have mentioned in Medicare savings that would be program savings, almost $2 billion of that $5 billion could be achieved just by extending certain provisions that are now law.

That's no small amount of money, and to get an equivalent amount through enforcement would be very difficult.

In any case, I think we should do both. We can get the savings from program changes—not necessarily all of the ones that we asked for. CBO has suggested over $6 billion in program-related savings which they suggest could be done without what they would call deep cuts or harm to beneficiaries. I would hope that we could reach some sort of agreement on responsible programs savings and—to the extent that additional enforcement is appropriate as well—that too.

Mr. GIBBONS. Well, I will look with an unbiased eye to your suggestions of program enforcement, but I want to tell you unless we do something about enforcement of the existing law on just an honesty basis, we are allowing the hospitals and other facilities, including the doctors, to get away with large amounts of funds, in my opinion.

Now, I voted for Gramm-Rudman-Hollings, but the bookkeeping system in Gramm-Rudman-Hollings stretches my confidence. Using the Social Security reserves to count, as they do under Gramm-Rudman-Hollings, is really playing a cruel hoax on the future generations of America.

Do you foresee any time when the administration would be willing to come in and say "we cannot count the reserves as we now do under Gramm-Rudman-Hollings?" Do you all have that anywhere in your game plan?

Mr. DARMAN. Yes, Mr. Gibbons. I think there is a problem with the way in which Social Security is treated in Gramm-Rudman-Hollings. It masks, to some degree, what is a larger deficit, and that, of course, is not a surprise to the administration or the Congress. That was known when the Gramm-Rudman-Hollings targets were chosen.

So I think that if we were going to change the accounting, you would also have to change the Gramm-Rudman-Hollings targets or else you create a completely impossible problem immediately of an extra $60 to $80 billion or more that you would have to find in savings or revenue.

I do not think we should do it at this time. I think that if we open up the issue of what are the Gramm-Rudman-Hollings targets at this time, before we have even agreed on any program savings, it would send a terrible signal to financial markets. It would look like we were trying to duck our responsibility again. The time to do that is after we have reached an agreement on a set of substantive proposals that are credible that could bring the deficit down.

After we have reached a substantive agreement on those, then the administration would certainly be willing to work with the Congress on a better accounting system for the future target and enforcement mechanism. I think that is desirable.

I might just say, Mr. Gibbons, that while I have said that it is desirable, I do not think it is quite as urgent a matter as some are suggesting. I am not trying to pooh-pooh this, but the Social Security trust fund keeps building and building and building and then does not—if you believe the estimates—turn negative until I think it is 2018 or some year like that.

So we have got a few years in which we can begin to adjust.

Mr. GIBBONS. I realize that we have a few years, but they are very few years in my opinion, and I applaud what you said that the accounting system does need correcting. Do you have any target date in your mind as to when the administration would be willing to sit down with Congress and adjust these targets?

Mr. DARMAN. Yes, sir. We would be willing to at least talk about changing the accounting system for Gramm-Rudman-Hollings right at the tail end of a negotiation if it were a serious negotiation on deficit reduction.

In other words, we are not saying sometime in the distant future. If we had a responsible, agreed deficit reduction program, at the tail end of that process I think it would be appropriate to look at both budget process reform issues and accounting issues.

Mr. GIBBONS. So you are saying that is possible this year? Is that correct?

Mr. DARMAN. I think that if we were reaching a serious agreement—one that could really bring the deficit down—then yes it would be possible this year.

If not, I think it would be a very bad signal to the financial markets. Once we open that subject up, there is, as you know better than I do, sir, there is potential for an enormous amount of gaming and gimmickry that would get almost everything off-budget, and we would have a worse system than we have at present if it is not done responsibly.

Mr. **Gibbons**. Well, my time has expired, but I was going to ask you how much of the Bush proposal to protect the depositors in the S&L's is going to be off-budget, and how much borrowing are you advocating?

Mr. **Darman**. Every single dime for which the Federal Government would in any way be responsible, we would propose to treat on-budget. The only issue that I am aware of that arises as to whether it should be on- or off-budget is an issue regarding $50 billion in bonds for which where the Federal Government is responsible for the interest under our proposal. We say to the extent that the Federal Government is responsible for the interest, to put every dime of that interest obligation on-budget.

But with respect to the $50 billion in principal, there the Federal Government does not have one thin dime, nickel, penny—it has zero obligation whatsoever. That principal, under our proposal, is fully covered in advance by the purchase by private parties—the S&L industry—of zero coupon Treasury bonds to cover the repayment of that principal.

There is no way at all that the Federal Government could be asked to step forward and cover one dime's worth of that principal; and so, with respect to that, we say the principal should not be on-budget. But every element of the plan that would in any way involve an obligation of the Federal Government—every dime's worth—we would put on budget.

Chairman **Rostenkowski**. Mr. Schulze will inquire.

Mr. **Schulze**. Thank you, Mr. Chairman. Thank you, Dick. I know you are tired of hearing about ducks, but I want to get a little more specific and see whether they are mallards or pintails, or what they are.

I would like to read off a couple of items which would have a revenue-raising impact, or revenue-enhancement impact, and have you tell me whether you would consider them a new tax, or a tax increase.

The first one would be the capping of cafeteria-style employee benefit plans. Take each one, if you will.

Mr. **Darman**. I have not thought carefully about that one. I submitted a response to the Government Affairs Committee, when I was being confirmed, with respect to the larger issue of employee fringe benefits, in which I suggested that in some cases, definitional changes—and I mentioned, in particular, cafeteria plans in response to a further question—that in some cases those might not be construed as tax increases, or ducks.

And I said that when you get to this very, very gray area it becomes not so much an academic issue—and this is where the duck test arose—as a question of whether it is perceived to be a tax increase, and it is a political judgment at some point. But that one strikes me as in the gray area.

Mr. **Schulze**. How about an airline departure fee which could be a user's fee? It seems to me most nations of the world today—even every little country you go through—puts on a $3 to $5 departure fee every time you leave.

Mr. **Darman**. It would depend on the purposes to which the funds were applied. If the funds were applied in a way that accrued solely to the benefit of the traveling public in rough proportion to the amount that individuals are paying in, then I think it would be fairly called a user fee.

If the proceeds, however, were allocated to another purpose, or allocated in a way that did not correspond to the payment in by the individuals, then I would say it would be a tax.

Mr. SCHULZE. We now have in the Tax Code some sort of special exemptions which are carved out. For instance, the wire services do not pay a telephone excise tax. They are one of the few who do not. If that exemption were eliminated, would you consider that a tax, or just an adjustment to the code?

Mr. DARMAN. That one is another one that I have not specifically considered.

Mr. SCHULZE. I am using that as an example. There are other such exemptions but I am using that as a specific example.

Mr. DARMAN. I think if it were considered to be in the nature of a loophole, where the general purpose or intent was to have included exactly such uses, then you might have an argument that it is "loophole-closing". But obviously, from the perspective of anybody who is going to pay the increase, it is a tax.

Mr. SCHULZE. The Oversight Subcommittee has been taking a long look at unrelated business income tax. Have you had a chance to look at that? If we do something in that area—the purpose would be to correct some inequities, not to increase taxes. If, as a result that brought in additional revenue—what would you think?

Mr. DARMAN. Again, it would depend on the particulars.

Mr. SCHULZE. How about amortizing a portion of advertising expenses over a period of time, say, a 2-year period, because of the concept that advertising does have a tail, and does have a long-term effect?

Mr. DARMAN. I think that that would be viewed as a tax increase.

Mr. SCHULZE. As a tax increase?

Mr. DARMAN. I am inclined to think so; yes.

Mr. SCHULZE. Well, in regard to that, when Pepsi Cola pays Michael Jackson $5 million for cutting a commercial, do you feel that the total $5 million should be deductible in that year?

Mr. DARMAN. Well, this issue, as you know, came up in the context of tax reform at one point, and I know it— depending on how you structure it—can produce an awful lot of revenue, and there is a good substantive argument for it.

But if you are asking the narrow question, would it be viewed as a tax increase, I think the answer is yes, it would.

Mr. SCHULZE. All right. Let me give you another example. If a company spends $200,000 or $300,000 to have a tent on the 18th fairway of a major golf tournament, and entertains mostly their executives, and so forth, should that be deductible in that year?

Mr. DARMAN. Well, again, the point is—or at least there are two separable questions. One has to do with the tax policy question per se—is it desirable as a matter of tax policy—and the second one has to do with the definitional issue you were raising—is it a tax increase as it would have been defined under the "read my lips" heading?

And I think with respect to the second, it would be viewed as a tax increase. I'm not judging the merits of the tax policy question.

Mr. **Schulze**. Two other very brief questions. First of all, your personal opinion on this. Is it in our Nation's best long-term interest to look at some form of consumption tax in light of what Canada, and Japan, and most of our other major trading nations are doing?

Mr. **Darman**. Over the longer term, I think as there are further changes in the character of our Tax Code, it would be desirable to have the system tilted less toward consumption, but I do not favor the imposition of a broad-based consumption tax for a host of conventional reasons.

But should we be, over time, trying to tilt our system away from its excessive orientation toward consumption? I think the answer is yes. I am speaking strictly in the way that you asked.

Mr. **Schulze**. If you have any suggestion on how we do that without a consumption tax, I would be happy to have it.

[The following was subsequently received:]

Instead of taxing consumption, we should enhance incentives to save and invest. President Bush has proposed a reduction in the tax rate on capital gains. This will boost the expected return to investment and will tend in the long run to shift production away from consumption goods and toward capital goods. As you know, there is some dispute about the revenue effects of such a change, but we believe the bulk of the evidence suggests that this proposal will increase revenues. Eliminating the double-taxation of dividends, once at the corporate level and again at the individual level, would also spur investment.

Mr. **Schulze**. Now my final question is this. Tell me your thoughts on multi-year budgeting.

Mr. **Darman**. Well, I think multi-year budgeting is desirable for a host of common-sense reasons. As a practical matter, I think the most that we can expect to get out of the Congress I mean, collectively, the most we could get—would be 2-year budgeting, which would be better than what we have at the moment.

Mr. **Schulze**. Are you shooting for that now?

Mr. **Darman**. Yes. We would like to reach a 2-year agreement, and if we reach a 2-year agreement, it will have been two times in a row that we will have done that. We will have set a good precedent, and maybe we will be able, collectively, to talk about process changes to try to institutionalize that. But if that offends people, I would say that is less important than first reaching the 2-year agreement this time.

Mr. **Schulze**. Thank you.

Mr. **Gibbons** [presiding]. Next, Mr. Stark, and after that Mr. Downey. Excuse me. Mr. Matsui.

Mr. **Stark**. Thank you, Mr. Chairman, and welcome, Richard, to the committee.

Much of your domestic cuts program comes out of a program that you probably started in your Government career, and a program which is very important to us on the Health Subcommittee.

I would like to focus, just for a minute, on the Medicare cuts. The absolute size of the cuts, I suspect, is a matter of negotiation within the budget process, and I merely point out that under Gramm-Rudman, we would only have $2.2 billion in a sequester as opposed to the $5 billion you are recommending.

And I do not know what that does in terms of a strategic position as you negotiate with the Budget Committee, but it seems to me that a sequester is closer to a reasonable fair share, in this case of what Medicare ought to provide.

Within this structure of your Medicare cuts, you have taken about 75 percent of your cuts out of the part A, the hospital part, and only 20 percent out of the part B, which primarily goes to physicians.

Wouldn't it be more fair—seeing as the hospitals in the past years have suffered the biggest cuts—to make that a little more even and take 40 percent out of the part B, as is their percentage to the total?

Mr. DARMAN. Well, Mr. Stark, may I first respond to your point about sequester?

Mr. STARK. Sure.

Mr. DARMAN. I think you are right, that Medicare would fare more favorably under sequester than under the proposals that we have put forward.

But I do not think anybody should favor the sequester option. I just thought I had better be clear about that.

Mr. STARK. No, I was not suggesting you would, but from our standpoint——

Mr. DARMAN. But I need to clarify something else, too. Nobody should favor it unless it is the best we can do.

Defense would be hurt by it. Domestic discretionary programs, as you know, would be adversely affected.

Mr. STARK. I think defense would be helped by it, as would Medicare, but reasonable people can differ on that. I would rather see a bigger cut come out of defense, and I would spend a little extra in Medicare, if I had my way, but I do not think I could win that one.

Mr. DARMAN. But in any case, there are adverse effects on the domestic side from sequester—outside of Medicare—is the only point I wanted to make.

Mr. STARK. I appreciate that.

Mr. DARMAN. It is not just defense. And some of them are in areas that affect the poor, and it is not just what are sometimes called Republican programs.

That said, I should say further that if we do not reach an agreement, I think it is important that we go ahead and take the sequester because I think, again, from the standpoint of financial markets, if we were to just throw up our hands and change the law, and slip away one more time, that that would be highly undesirable.

That said, with respect to your Medicare proposals, you are right about the break, at least roughly, in terms of hospitals versus doctors.

We would be happy to work with you on alternative proposals. We have taken pains to try to suggest that we recognize there are many different ways to get at cost control in Medicare, and we would be interested in working with you to find what we would jointly think to be the best ways.

We do not contend we have got the absolute best ways. I would not personally start with an arbitrary target as to how much should be doctors and how much hospitals.

I would rather look at it programmatic suggestion by programmatic suggestion.

Mr. STARK. Well, that would be all right with us, except as to say that we have, over the past years, taken, proportionately, a lot more out of the hides of the hospitals through part A cuts which were almost automatic.

Along that line, you might help me and some of the hospital financial folks in planning if I could ask you this.

The present law requires that capital reimbursement, which is one of the items of your cuts, be built into the DRG payments by October of 1991.

Now if you put regulations into place that will cause a budget savings by the fact of putting the regulations in, and also sort of predetermine how we will have to react, could you share with us any plans that you may or may not have to implement this provision on the calendar of regulations, so that we will know whether capital will be folded into the DRG's, or will not, and if so, when.

Because as we try to plan to work with you to achieve savings in Medicare, that would be pretty important for us to know.

Mr. DARMAN. It is our intention to move in the direction of folding capital in. The regulations are still under development, but it would be our intention—I am prejudging the way that is going to come out but I believe that it would be our expectation that the regulations would go ahead and fold capital in.

Mr. STARK. What I am getting at is: do you think we will see those regulations before our subcommittee has to really prepare its reconciliation bill?

Mr. DARMAN. Just 1 second, let me find out the current status.

Mr. STARK. All right.

Mr. DARMAN. Well, I do not have a fully satisfactory answer. Apparently HHS is, at least in the judgment of OMB, is holding them up at the moment. But we would be happy to work with you on that, and I think that if our moving them forward would adversely affect our ability to reach a larger agreement, then I would be happy to have us hold off.

But on the other hand, if moving them forward can be done in a way that seems to be not harmful to the larger interests we are seeking here, then I would propose we move them forward quickly.

I do not understand, at the moment, why HHS is holding them up.

Mr. STARK. Thank you. One last question and that is in the kinder, gentler area. I think we would both agree, that whatever savings, and in whatever way we find savings in the Medicare program, we would try and protect the beneficiaries from hardship as best we can, both in terms of access and cost.

And to that extent, are you willing to do battle with us as we talk about reimbursement plans on the part B side, to see that excess billing to beneficiaries just do not get raised to automatically cover any savings that we make, thereby getting it passed on to the beneficiaries as an automatic increase?

Mr. DARMAN. I am not sure I understand exactly what you mean.

Mr. STARK. Well, I am talking about limiting extra billing. If we cut high-priced procedures, as we have in the past, we also try to make sure that the physicians cannot just add that extra cost on to the beneficiaries, and the same would come in hospital charges or other things. Outpatients. I think there is going to have to be some more control on costs by the providers as we squeeze on this side, and——

Mr. DARMAN. I guess we would have to see what the proposed control mechanisms were in that respect. It is a tough matter, at least for me. I have not looked at that, specifically.

As a philosophical matter, one is driven, as you know, towards tighter and tighter controls, and more and more regulations stretching farther and farther and farther because of the character of the system.

Mr. STARK. The regulations and controls are in place. It just leaves the cap there, and that will be a bone of contention, I am sure, but it is the other end of this cost squeeze.

Mr. GIBBONS. Pete, I am sorry. We are all out of time.

Mr. STARK. Thank you very much.

Mr. GIBBONS. Next, Mr. Matsui, and then after that, Mr. Gradison.

Mr. MATSUI. Thank you very much, Mr. Chairman.

Mr. Darman, I think one of the areas that I have a real problem with, with respect to the President's budget, is some of the economic assumptions that he sets forth in the budget.

All appearances are that inflation is going up, and interest rates, contrary to the President's approach, are going up as well. Could you comment on that, please.

Mr. DARMAN. Yes, Mr. Matsui. We, as you know, attempted to adjust—in fact did adjust our economic assumptions relative to President Reagan's—but with respect to interest rates, we raised them to reflect the fact that the Reagan assumptions were quite a bit out of line with the current market.

Mr. MATSUI. Well, I think you have raised them from the Reagan numbers, but it still is a decrease of about 1.5 percent, if I am not mistaken.

Mr. DARMAN. Well, no. Actually, we are right at the current market, but the question is the slope at which we come down, which is very steep, and that is where I think the difference between us would be and where we should focus.

We are making an assumption of a budget agreement that produces very serious deficit reduction, and that that agreement be relatively prompt.

If those assumptions are not met, if those conditions are not met, we would not forecast this kind of sharp interest rate decline.

I might say three further things. One, clearly this is optimistic. Two, the Chairman of the Fed has said, however, that if we were to achieve a responsible deficit-reduction plan of the type we are talking about, promptly, he would expect a sharp interest-rate decline. We have had sharp interest-rate declines before. Whether there would in fact be one in this context, or not, is arguable. We think it would be fairly sharp, and the Chairman of the Fed seems to agree.

A final point. If we are wrong—as of course we may well be—we are probably wrong not only on the interest rate, but we are also probably wrong on the inflation rate assumption, and they tend to work in opposite directions in terms of the effect on the deficit estimate.

If you assume that we are wrong, in equal amounts, on both inflation and interest rates, then the effect on the deficit is very, very small.

Mr. MATSUI. Well, Dick, I would like to comment on that. If you recall, in the 1970's, we did see simultaneous increases in interest rates and the inflation rate. So that theory is not necessarily accurate, depending upon the state of the economy and the financial markets' confidence in a number of factors.

Mr. DARMAN. What I am saying, Congressman Matsui, is that if interest rates are higher, it is going to be probably partly because inflation is higher than we are forecasting. If they are both higher than we are forecasting, then the combined effect on the deficit is minor. If only interest rates were higher, than the effect on the deficit would be very significant. But if both interest rates and inflation are higher, the effect on the deficit is small because as inflation rises, revenues rise, and the offsetting revenue effect is significant.

Mr. MATSUI. The only reason I raise this issue is because I recall about 7 years ago, in 1981, when Dave Stockman appeared before our committee, he predicted a balanced Federal budget by 1984 based upon certain rosy economic assumptions, and the Reagan economic program.

Mr. DARMAN. But you know one curious thing—if I could interrupt—about those assumptions? If you go back and look at those assumptions, they were too pessimistic on interest rates and inflation.

Inflation and interest rates came down much more rapidly then was actually forecast by him.

Mr. MATSUI. Well, that is true.

Mr. DARMAN. But so did some other things, unfortunately.

Mr. MATSUI. That is true, mainly because we were in a recession for about 2 years.

Mr. DARMAN. That is right.

Mr. MATSUI. And of course interest rates and inflation usually go down when that happens. So I would not consider that to be a——

Mr. DARMAN. Yes. I would prefer not to do it that same way.

Mr. MATSUI [continuing]. Good victory in terms of the administration. Let me just ask one more question because my time is running out.

In terms of the capital gains proposal, the Joint Tax Committee has indicated, over a 5-year period, we will witness a revenue loss in the range of about $16 billion over a 5-year period.

Under law, we are required to score whatever we do on the tax side by using the Joint Tax Committee's numbers. We cannot use OMB's and the CBO's. We have to use Joint Tax's numbers.

In view of the fact that Joint Tax has indicated this is a revenue loser, unlike your economic assumptions and unlike your projections, isn't it about time that the President finally says that we cannot do anything on capital gains because it is a revenue loser under the assumptions that we must use?

Mr. DARMAN. No. I do not think so.

First of all, I should note that in putting our own budget together, we did not rely upon the capital gains positive revenue number in order to meet the Gramm-Rudman-Hollings targets.

And as you know, there is a positive number estimated by both us and the Joint Committee for the first year. The difference is in the out-years.

The administration is working with the Joint Committee on Taxation—staff to staff, technical people to technical people—to try to resolve the differences, and I would hope that their estimate might move in our direction some, because I am led to believe that ours is a responsible analysis, and that we could at least close the gap in terms of the difference between the two sets of estimates.

Mr. MATSUI. If I can just follow up, Mr. Chairman. I know my time has run out. I just want to ask one further question, or comment here. I realize that the first year would show revenue gain because of pent up holdings. But we must look at this for the long-term, as you suggest in your opening remarks.

Assuming, for a minute, that in your negotiations with the Joint Committee on Taxation, you still, over a 5-year period, will have a substantial loss in the $10 to $12 billion range.

Will the President then say that we cannot do anything on capital gains because it is a revenue loser?

Mr. DARMAN. No.

Mr. MATSUI. Is he still going to deny reality?

Mr. DARMAN. I do not believe that that is reality. What that is is one group of people's estimate, and I might just note that our estimate and their estimate does not include any favorable growth effect from capital gains.

The estimates are based entirely on what we take to be people's realization behavior; nothing in terms of the effect on entrepreneurship, further investment in long-term capital, and so on. Nothing.

So I would not think that we would withdraw our interest in the proposal just because the Joint Committee did not estimate it the same way.

Mr. MATSUI. Dick, I think that would be very misleading to the American public.

Mr. DARMAN. Which would?

Mr. MATSUI. If the President would continue to press his capital gains proposal, even knowing, after negotiations, that Joint Tax says it is a revenue loser over 5 years, I think it is very misleading.

Mr. GIBBONS. I am sorry. We have to cut this off. Mr. Gradison and then Mr. Anthony.

Mr. GRADISON. Thank you, Mr. Chairman. Mr. Darman, one of the proposals in here is an old chestnut which would impose, immediately, the Medicare tax on all State and local employees.

As you know, many of us felt this issue was laid to rest by a compromise reached some years ago which does apply this tax to new hires, but does not go back and reach those who were employed by State and local governments prior to a date early in 1987.

In my State of Ohio, this is viewed as a tax increase. How would you respond, if you were talking to an Ohio official, or in this case, an Ohio representative, about that particular matter?

Mr. DARMAN. I would ask if we could have some people from some other States in the room.

Mr. GRADISON. Well, we do, and if the previous voting of this committee is any indication, I daresay that we would find—if the last votes are any gauge, that there probably is not 1 member in 4, or 1 member in 3 on this committee that would support your proposal.

Mr. **Darman**. I understand, sir, but I was just being a little bit facetious. There are only two States, I believe, in which——

Mr. **Gradison**. This is a serious matter to people in our State.

Mr. **Darman**. I understand.

Mr. **Gradison**. Because it would call upon the State, and every subdivision of it, to come up immediately with an additional 1.4 or 1.5 percent of payroll, on the bulk of their payroll. .

Could you submit to us the data, State by State, that would add up to the increased collections which you are projecting from this levy, please.

Mr. **Darman**. Yes, I could.

[The following was subsequently received:]

Estimated distribution, by State, of additional receipts in Fiscal Year 1990 from the proposal to extend medicare hospital insurance coverage to all State and local government employees
(millions of dollars)

State	Amount	State	Amount
Alabama	$ 10	Nevada	$ 18
Alaska	22	New Hampshire	1
Arizona	10	New Jersey	23
Arkansas	2	New Mexico	11
California	501	New York	48
Colorado	79	North Carolina	12
Connecticut	38	North Dakota	1
Delaware	1	Ohio	272
Florida	33	Oklahoma	8
Georgia	25	Oregon	4
Hawaii	5	Pennsylvania	19
Idaho	1	Rhode Island	8
Illinois	159	South Carolina	2
Indiana	17	South Dakota	1
Iowa	4	Tennessee	10
Kansas	4	Texas	218
Kentucky	24	Utah	2
Louisiana	98	Vermont	1
Maine	19	Virginia	15
Maryland	10	Washington	11
Massachusetts	170	West Virginia	1
Michigan	19	Wisconsin	13
Minnesota	24	Wyoming	1
Mississippi	1		
Missouri	26	Other	21
Montana	1		
Nebraska	3	Total	2,027

Note: This distribution is based on estimated total State and local wages not covered under social security, by State, in 1984. Factors which may cause the actual distribution of new receipts in Fiscal Year 1990 to differ from this estimated distribution include:

1. Variation by State in employment growth between 1984 and April 1, 1986
2. Variation by State in pay levels between 1984 and 1990.
3. Variations by State in attrition rates of the closed group of noncovered employees.
4. State variations in the ratio of taxable to total wages.
5. Estimating error in the original 1984 distribution and in the size and earnings of the closed group in 1990.

Social Security Administration
Office of Research and Statistics
March 8, 1989

Mr. **Darman**. But could I say one thing about it?

Mr. **Gradison**. Sure.

Mr. **Darman**. The percent of people in State employment covered under HI as of 1984—at least according to the numbers I have got here—was zero in Ohio and Massachusetts. They are the only two at zero, so they will be the two hardest hit by this.

There is a handful of other States in which the numbers are low, but it is only a small number of States. Of course you are from a State which is one of the ones at zero, and I understand the nature of the interest.

There is a larger issue of fairness, I think. I do not think it will make anybody who has got to pay more feel good, but there is a larger issue of fairness.

There is a large number of people who are getting the benefit without paying for it, and people from other States can legitimately ask why should they in effect be subsidizing the people who are not paying?

That is the issue. I know it does not make people in Ohio feel good, but there is a flip side to this.

Mr. **Gradison**. Well, unless there be some misunderstanding, let me state very clearly: Nobody gets the Medicare benefit unless they meet the requirement of having paid in, along with their employer, the requisite amount for the requisite period of time.

But I would look forward to receiving the numbers from you for each of our States.

One other thing I wanted to discuss with you.

I, as you know, have been troubled by the financing which the administration has proposed for the FSLIC bailout as to the payment of the interest.

I have been at a total loss to understand why we should issue debt which is not full-faith-and-credit debt, knowing in advance that that will carry a higher interest, producing not only higher expenses for somebody—either the savings and loan business, or the Treasury—but also, a windfall to the purchasers.

It seems to me that the debt could be full faith and credit, and we could still collect the maximum amount which the administration has recommended from the industry towards the principal and the interest on that debt.

And since we are involved in all debt issues in this committee, I would appreciate knowing why you think we should incur that extra expense which is estimated by the Congressional Budget Office—not just me—to be at least a $100 or $200 million every year.

Mr. **Darman**. There are three points I would make. One of them you alluded to, and that is that under our approach we do at least have industry agreement, by and large. At least four of the five major industry interest groups agreed to the approach. And for industry contributions in the amount that we seek, whether they would be in favor of an alternative plan, making similar contributions, I do not know. It is speculative.

We have one in hand where we know we can get the industry to pay, or think we can get the industry to pay a substantial amount.

Second, if you score it differently you will create an enormous Gramm-Rudman-Hollings problem at a time when I think our financial markets are nervous. If we complicate our ability to reach an agreement on deficit reduction, it will have an adverse effect on interest rates, I think.

If that happens, the overall cost of the plan will go up by amounts that just dwarf the tiny little difference in the spreads that is involved here.

Finally, on the difference in the spreads, it depends on your assumptions about how long we have an inverted yield curve. If you assume that we were going to fund this with Treasuries in the current context, or in a context in which the inverted yield curve is going to persist, and if you assume that the Treasury is not going to change its average maturity and financing, then its current average maturity is almost 6 years.

So you would have to look at the 6-year rate compared with the long-term rate, and the 6-year rate today is substantially higher than the long-term rate—more than the amount of the difference that is estimated to be the difference between the new bonds, long-term, and Treasuries, long-term.

So in other words, if you assume you are financing with Treasuries in the context of an inverted yield curve, and you do not change the average maturity of the overall Treasury funding, it would actually be cheaper to do it with 30-year bonds paying 15 basis points more—in the way that we propose—than it would be to do it at the higher rate of the current 6-year rate with Treasuries.

Mr. GRADISON. Well, Mr. Chairman, I just want to comment. I have spent a life-time in the securities business, and if Mr. Darman can show me any existing agency that is trading as close as 15 basis points above Treasuries, I would like to take a look at it.

I think there has been a consistent effort to understate the costs of this to the taxpayers, and to the savings and loan industry, and to gloss over the windfall that would go to the purchasers of these securities, and I think that 15 basis points is—it is not only highly unlikely and not demonstrated by what has been going on in the markets over the years, but at an earlier hearing I believe you said 25 basis points.

Mr. DARMAN. We did.

Mr. GRADISON. Has it come down 10 basis points?

Mr. DARMAN. No. I am glad you noted that. Our estimate is based on a 25 basis points difference. Even at that the number is very small, and we have done, and we will provide to you as well, sensitivity runs on what the cost would be. Assuming that that were not right, the 25 basis points.

It is not very far off of where they are likely to trade because there is a very large issue with lots of liquidity and complete Government backing of the interest, and the principal is already wholly covered by Treasury zeroes.

They are likely to trade, we think—and outside investment bankers have said—at a 15, 20, or 25 basis points spread. Anyhow, we used the higher end of the range. We used 25 basis point in our estimate, not what I just said, which is my own guess about where they might trade. We used the 25 basis points.

And even at that, though, the difference between a 6-year maturity today, and the 30-year is on that order—I think 94 versus 92, something like that—20 basis points. So they are not that far out of whack.

Mr. GRADISON. Thank you, Mr. Darman. Thank you, Mr. Chairman.

Mr. GIBBONS. I thank you for that excellent cross-examination there, and I just want to say, before I go to Mr. Anthony, I think it is a moral question. I think our generation caused this mess. I think our generation—yours and mine—ought to pay for it, and I am not for pushing this off to our children and grandchildren. Mr. Anthony.

Mr. ANTHONY. Thank you, Mr. Chairman. Welcome, Mr. Darman. I am just curious—over the last 15 or 20 years—I wondered where your residence has been. Where have you lived?

Mr. DARMAN. In Virginia.

Mr. ANTHONY. Rural Virginia or urban Virginia?

Mr. DARMAN. Urban. Well, it is suburban Virginia.

Mr. ANTHONY. What I do not understand is why there is such an implied bias against rural America in the budget that has been presented to the Congress, and let me just quickly go down some areas.

When I go back home and explain what doing away with current service budgeting means, here is what I read it to mean. Number 1, the President wants growth, economic opportunity for enterprise zones, but he wants to put them in urban areas. He does not want them in rural areas. I do not understand why we are not entitled to have growth, hope, and opportunity in a rural area as well as an urban area.

On your capital gains provision, we grow an asset down in my part of the country, and it takes 50 years before it gets large enough to maximize its marketability, yet when it is harvested it is made into pulp, pulp turns into paper, you throw a little ink on it, and you call it a stock certificate from an existing company. You hold it 1 year, and you get a capital gains on it, yet you have all this risk of fire, insects, and everything else for 50 years, and you do not get a capital gains on it.

Those are not grown in New York City or Washington, D.C. They are grown in rural areas. I just do not understand why you would be biased against capital gains treatment for these assets. Let me just quickly go down eight programs, and tell you what I have got to tell my constituents what current service budgeting elimination means.

If they are a new farmer wanting to go into farming, and they would like to go to Farmers Home Administration, that program would be eliminated if your budget passes.

If they want to go into rural housing, I will have to tell them that there is a $1.7 billion elimination of current housing loan programs under the housing program, and that the affected units drop from 45,000 to 25,000.

If I tell them that they want some community facilities, I will have to tell them, well, that program is totally eliminated.

If they want to implement conservation cost-share, so that they can save valuable farm land from flood and erosion control, especially in areas of river bank stabilization, I will have to tell them that that program is almost eliminated, not entirely eliminated.

If they want to try to put some trees on erodible land under a cost-share program called the forestry incentive program, I will have to tell them that the program is now eliminated—$800,000 to $900,000 was used in Arkansas last year for that program alone.

If they happen to be receiving telephone services and electrical services from their co-ops in Arkansas, I will have to tell them that that has been eliminated because they will not have direct access to the Federal Finance Bank. Therefore, their utilities and their services are going to go up, a hidden tax, if you will, on rural families, farm families.

Again, if they are in the forestry industry and they have State and private forestry programs, and they are used to operating on those grants for the State, I will have to tell them that the program would be eliminated.

I would also have to say that if they would like to apply to the center for appropriate technology transfer for rural areas—in other words, a center that tries to teach us how to do better in rural areas—I will have to tell them that although that program is going to be moved from Memphis to Fayetteville, Arkansas, that the budget will eliminate the total program altogether, so they will just have to go do it on their own.

And then, in the State of Arkansas, we have aquaculture. Mississippi, Alabama, Louisiana, all have aquaculture. Maybe you have tasted some of our farm-raised catfish. It is becoming very popular. The market is greater than the supply at the moment, and personally, I think it has a great future, not only for health reasons but also for export reasons.

And I will have to say to those people who would like to expand into that area, that the budget calls for elimination of cooperative State research service facilities, so that the future of that industry would be threatened.

That is just eight programs that are totally eliminated. I have about 15 others that are severely handicapped because they are practically eliminated simply because they are cut.

And my basic question is this, Mr. Darman. Why is the administration targeting rural America? Why don't you want to help rural America?

Mr. DARMAN. Congressman Anthony, I do not think it would be fair to say that the administration is targeting rural America. Certainly, it is not a point of view I have heard expressed in any of the meetings that I have participated in.

So could we put that aside and just talk about the actual substance of the program? When it comes to motivation, I believe that there has been no motivation to be prejudicial against rural America.

Mr. ANTHONY. Just take the free enterprise zones. Why would you want them only in urban areas and not rural areas, from a budgetary standpoint?

Mr. DARMAN. Well, the President, during the course of the campaign, said that he would like to explore the possibility of enterprise zones being extended to rural areas. I think that in the course of the design of this program—we have not submitted the exact specifications on this—we would certainly be open to looking at that. The problem is that we have got, once again, an issue of revenue-estimating, and as long as you estimate substantial revenue losses associated with enterprise zones, you are very, very limited in the number that you could designate urban or rural. That is another technical matter we have got to sort out, both among ourselves and with the Joint Committee.

But on these other programs which you mentioned, in the case of the loan programs, they are not eliminated, they are switched to guarantees. So that they are not gone altogether.

The housing program you mentioned is not eliminated, there is a switch to vouchers, although I would grant your point that the number of people served would decline.

But the most important thing I would say is with respect to that host of other programs that you mentioned that are eliminated or reduced, I believe—listening to the quick recitation there—I believe every one of them is in this area we call the residual freeze area, which means that we have presented three different options for every one of those programs.

One of them is at the Reagan program level, and that is what you are referring to, I believe.

The second is at a nominal freeze, where the program is held to the exact same level this year as last year. So in those cases it would not be eliminated, or even substantially cut.

And the third option that we presented is the one that we think is the real option, which is yet to materialize. It is identified as to be negotiated.

We have said with respect to all of these, that we are not adamantly trying to eliminate the programs that were in the Reagan preferred elimination list. We are trying to negotiate with the Congress to come up with the best possible mix with respect to this whole set of discretionary programs—some of which can go up, some of which can go down.

All we care about is that the total stay within a reasonable limit. I should not say that is all that we care about, but that is the number one thing we care about—that the total stay within a reasonable limit.

Mr. GIBBONS. I am sorry, Beryl. That red light is cruel out there. Mr. McGrath. Mr. Brown. Mr. Chandler.

Mr. CHANDLER. Thank you, Mr. Chairman, and welcome, Mr. Darman, to the committee.

I represent the Pacific Northwest, as you know, and I also am aware that you know that the President's budget contains a proposal for accelerated debt repayment for the five regional Federal power marketing administrations, a proposal that would raise an estimated $1 billion in new revenues of which about half of that—$550 million—would come from the Bonneville Power Administration which serves the Pacific Northwest.

Now, in Senate testimony, you indicated in response to a question from Senator Hatfield, that this proposal would be expected to result in BPA power rates increasing by about 35 percent.

And you also noted that you had seen more optimistic projections of rates rising by only 20 percent.

Now my question is, if we were to use more pessimistic assumptions on interest rates, on aluminum prices, how much could BPA rates be expected to increase under those more pessimistic assumptions?

Mr. **Darman**. I do not have the number handy, but could I clarify something that I believe is not accurately reflected in the version of the record you have, on the Senate side?

What I said, or certainly what I meant to say on the Senate side, was that we had a study indicating 20 percent that I was familiar with, that we had seen within OMB. Senator Hatfield had a study that said 35 percent. I have not actually seen that study.

The one that I am familiar with is the one at 20 percent. But I would be happy to have us do some calculations for you. I think the more significant point is that in any case, all that will happen is that the people paying rates under the Bonneville network will be paying rates—if this proposal were implemented—that would rise to the level of others in the region. Not higher than, but just up to others in the region.

Mr. **Chandler**. I want to make available to you a letter to one of our colleagues from Jim Jura, the manager of Bonneville Power Authority, who estimates that with a kind of a mid-level—neither optimistic or pessimistic assumption—that the rate increase would be 35 percent.

But he goes on to say, in his letter: "A more pessimistic set reaches 55 percent with correspondingly larger impacts on the region's economic infrastructure."

And even at a 35 percent increase, Bonneville estimates a loss of 13,400 jobs, both direct and indirect when you count the aluminum and pulp industries, its a loss of $265 million in income, and there is a loss of $100 million in State and Federal tax revenues; all of this, of course, is in an area that, at least in its rural part, has had some considerable economic difficulty.

Mr. **Darman**. We would be happy to take a look at that study. I promised Senator Hatfield that we would provide further analysis, and I would be happy to provide further analysis to you as well, of course.

[The information of Mr. Darman follows:]

ASSESSMENT OF BONNEVILLE'S ANALYSIS OF THE IMPACT OF REPAYMENT REFORM

BACKGROUND

The Bonneville Power Administration (BPA) sells wholesale from Federal dams about 73 billion kwh of electricity annually, making it the 13th largest utility in the country. Bonneville supplies about 50 percent of the electricity needs in the Pacific Northwest region.

Repayment Reform Proposal

The President's FY 1990 budget proposes to change the repayment practices of the BPA. The proposed repayment reform would require that the $7.3 billion in unpaid appropriation debt be repaid by Bonneville in a full and timely manner and that power rates be set to cover the full cost to the Government. Under the proposal:

- The unpaid appropriation debt would be amortized on a fixed, straight line basis not to exceed the lesser of the service life of the investment or 50 years.
- The interest rate on the unpaid balance would be set at the current cost of triple-A utility industry borrowing.

Under the President's proposal, BPA would no longer use "flexible" repayment practices which do not fully recover the true Federal costs. With "flexible" repayment BPA can unilaterally decide to postpone the principal payments on its appropriation debt and pay down its high interest Federal debt first leaving the lower interest debt unpaid until the end of the repayment period. These lax repayment practices have evolved administratively because the loosely written enabling statutes for most of the water projects in Bonneville's service area do not specify interest rates, repayment periods or schedules. As a result the statutory objective of repaying the Federal investment over a reasonable time period is not being achieved.

The reform proposal would also require that interest rates used for computing interest expense on the unpaid pre-1974 appropriation debt be increased from the original project rates to current market interest based on rates charged triple-A utilities, about 10 percent, instead of the current average interest rate of 3.3 percent Bonneville now pays on its appropriation debt.

Also, the irrigation investments which are to be repaid by power users and which currently bear no interest, would also be assigned triple-A utilities' interest rates. The irrigation debt is not scheduled to be repaud until after the interest bearing PMA debt is repaid. Consequently, the budget proposal would require amortization of this debt, as well. Interest rates on appropriation and irrigation debt would be adjusted annually.

Current Electricity Prices in Northwest

Because of the prevalence of hydropower resources and the existence of many Federally built dams, the Pacific Northwest has the lowest electricity rates and the highest residential electricity consumption of any region of the country. According to DOE's Energy Information Agency the average residential retail power rate in Oregon is 4.8 cents per kwh and is 4.16 cents per kwh in the state of Washington. These are well below the National average residential electricity retail rate of 7.5 cents per kwh. As may be expected, because the Northwest's rates are so low, the average monthly retail use of electricity is about 325 kwh or 42 percent higher than the national average.

Bonneville's current wholesale Priority Firm (PF) power rate (mostly residential customers) is 2.39 cents per kwh. The average retail rate for preference customers whose local utility gets 100 percent of its needs from Bonneville is 3.84 cents per kwh. This rate is:

- About 23 percent below the average of investor-owned utility power rates in the Pacific Northwest.
- Approximately 48 percent below the national average retail residential electric rate.

When discussing repayment reforms there is a tendency to focus on the percentage increases in power rates without recognizing that the resulting rates are starting out from such a low base, that after repayment reforms the rates are still well below every other region of the country.

ASSUMPTIONS IN BPA ANALYSIS

In order to assess the impacts of these reforms on ratepayers BPA and the other Power Marketing Administrations were asked to analyze the effects of the changes on electric rates. To assess the impacts Bonneville examined 3 different cases each with different assumptions. This assessment of BPA's analysis focuses on the middle, or what BPA calls the "most likely" case. In conducting the analysis BPA employed its existing models which it uses to annually estimate and develop rates and revenue estimates under varying physical and economic conditions. The models require a number of key assumptions on interest rates, demand elasticities, aluminum prices and revenue needs.

Most of the dire economic consequences of repayment reform which are alleged by BPA result from two key assumptions which Bonneville made in its analysis:

1. Higher retail power rates resulting from repayment reform will decrease electricity use (i.e. increase conservation) and will force customers to switch to cheaper suppliers of electricity. This in turn leads to unused capacity which Bonneville argues it will not be able to market on a comparable basis.
2. Large reductions in aluminum prices over the next 2 years when combined with an increase in electricity costs will result in severe load losses and the shut-down of aluminum plants resulting in large job losses.

Bonneville's assumptions which are examined below in more detail, are strongly tilted in favor of overstating the impacts of repayment reform under all three of the scenarios which BPA examined. Many of the key assumptions such as aluminum prices and interest rates are totally independent of BPA power rates and are specified externally to the models.

Interest Rate Assumptions

The long term triple-A utility interest rates used in the analysis are based on a 1988 study by Data Resources Inc. entitled U.S. Long Term Review. These rates are projected to the year 2000. The interest rates used are shown in table 1 where they are compared with BPA-projected Treasury bond rates for future BPA borrowing.

Table 1

Year	BPA Bond Rate	New AAA Utility Rate
1990	10.21	10.28
1991	9.85	9.76
1992	9.54	9.49
1993	9.46	9.48
1994	9.41	9.37
1995	9.35	9.26

The projected triple-A utility interest rates are roughly equivalent to BPA's projected bond interest rates for new Treasury borrowings. Since 1974 the interest rate at which Bonneville borrows from the Treasury has been statutorily fixed at six tenths of a percent above the Treasury's rate for 30 years bonds. However, this post-1974 Bonneville debt is not included in the proposal for repayment reform. The rates in table 1 indicate that with repayment reform Bonneville would pay interest rates on its unpaid $7.3 billion appropriation debt which are equivalent to the Treasury's cost of borrowing. This would eliminate the need for the taxpayers to subsidize the difference between Bonneville's current low interest rates and Treasury's cost of money. This can hardly be viewed as unfair.

At present the average maturity of Treasury's marketable public obligations is 4.7 years and the average interest rate is 8.8 percent. The $7.3 billion in Bonneville debt has an average interest rate of only 3.3 percent. Thus, taxpayers must finance the difference between Treasury's cost of money and BPA's average interest rate about $400 million per year. This interest rate disparity means that Federal taxpayers, who already pay their own higher utility bills, also help to keep BPA's rates low by paying part of the financing costs.

In addition to using the interest rates shown in table 1 for its "most likely" case BPA used interest rates in the 6 to 8 percent range for its "optimistic" case. Because these and the other assumptions used in the "optimistic" case are similar to current conditions or the assumptions used in the President's budget this review will refer to this case as the "base case".

Load Loss Assumptions

In its analysis Bonneville considered 3 separate load loss assumptions for each of the 3 cases it analyzed. For the "most likely" case BPA assumes that the electricity demands for its Priority Firm (PF) customers would decrease by about 200 average MW. Bonneville curiously, describes this projected increase in energy conservation as a negative effect of repayment reform. In fact, Bonneville currently subsidizes energy conservation for many of its customers. For example, Bonneville subsidizes aluminum company's energy savings (5 mills paid for each kwh saved), pays State and local governments to adopt and enforce a model building standard, provides financial "incentives" to builders and home buyers etc. Although paying such subsidies may be more cost effective than building or purchasing new capacity, it puts BPA in the paradoxical position of paying to keep electricity rates low (thus increasing electricity use) and paying for conservation activities (thus decreasing the use of electricity)!

In its "most likely" case Bonneville also assumes that with repayment reform the PF customers will displace an additional 300 average MW of BPA power with electricity purchases from less expensive Canadian and other suppliers. Bonneville then assumes fixed costs would have to be spread over a smaller load base further increasing the need for rate increases to the remaining customers. While there probably would be some customer load switching Bonneville does not acknowledge that these assumptions bias its analysis nor does it refer to the uncertainties in its analysis or the potential mitigating benefits of such load shifts. Bonneville's analysis of the impact of repayment reform is seriously flawed because of these oversights and biased assumptions.

- Bonneville does not acknowledge conservation benefits resulting from repayment reforms. There are clear benefits to BPA, its customers and the environment from the conservation which would result from repayment reform. Bonneville estimates about 200 average MW may be "lost" (it would be more accurate to say saved) under its "most likely" scenario due to an increase in conservation resulting from repayment reform. With such an increase in energy conservation Bonneville could also reduce the costs of subsidizing certain conservation efforts. These costs, which in FY 1988 amounted to $58 million and which is expected to increase to over $80 million in FY 1989, must presently be born by either ratepayers or taxpayers. Between FY 1981 and 1989 Bonneville spent an amazing $829 million on conservation activities. Much of this conservation would occur automatically if Bonneville's electricity rates were not held artificially low through Federal subsidies.

- Bonneville's analysis does not justify the projected load loss estimates resulting from customer switching. Because BPA is one of the low cost suppliers in the region it is not clear that current customers would or could obtain 300 firm MW elsewhere. And, Bonneville still dominates the transmission of power in the region. To bring 300 annual firm MW into the region under the "most likely" scenario would require BPA's participation in order to get assured access over the long time periods required. Even with its new intertie access policy Bonneville can strongly influence market access to the Pacific Northwest market.

- Loss of load would not result in increasing costs to BPA's remaining PF customers. Even if BPA did lose the 300 MW to lower cost suppliers (outside of Canada it is not clear that such suppliers exist for this much firm load), it could market this power elsewhere at a comparable or higher price and make more money. BPA assumed it would lose 300 annual MW of PF power which it sells for an average wholesale price of 2.39 cents per kwh. Last year BPA sold over 2.7 million MWh of power outside the region at an average price of 1.83 cents per kwh. Most of this power was sold to the Pacific Southwest to displace more expensive thermal generation. In FY 1988 BPA sold 676 thousand MWh of firm power to the California market at an average price of 2.15 cents per kwh. Bonneville's analysis correctly recognizes that its power sales to the south are used to displace high cost gas generation capacity. The price of gas, therefore, is the major factor determining the spot price BPA receives and the quantities demanded. However, in the "most likely" scenario BPA assumed the cost of generating electricity with natural gas would be 2.6 cents per kwh. Last year the average cost of gas generated electricity in Southern California was higher. Bonneville's assumption of very low cost gas generated electricity limits BPA's market and the price it would receive for the excess power. The gas price assumption for the "most likely" case is unrealistic. Bonneville could easily market the additional power outside the region at a price which is equal to or below that which potential customers are currently paying. For example, in March Bonnevvile sold 150 MW to the Sacramento Municipal Utility District for 2.4 cents per kwh. Both firm and spot sales of any surplus resulting from repayment reform will offset any BPA revenue loss. And seasonal power exchanges during their respective off-peak seasons (BPA has a winter peak and Southwest has a summer peak) will help keep Bonneville's costs and the regions utility rates down. Finally, it is not clear why BPA assumes this 300 MW would be lost to other suppliers rather than produce additional conservation because the cost of incremental conservation investments would become more attractive and thus provide more conservation-produced power for sale outside the region.

- Bonneville could also make profitable long term sales of surplus power within the region. Last year for example, BPA completed its first such sale to Puget Sound Power and Light for over a 20 year period at an initial price of 2.85 cents per kwh. If Bonneville made the effort additional intra-regional sales would be possible and would likely result in higher; not lower, BPA revenues.

- BPA does not address the fact that even if load switching did occur, the availability of this additional capacity may reduce the need to purchase power from outside the region. So far this fiscal year BPA purchased $41 million worth of power. Because this average purchase price is well above BPA's own price, eliminating such purchases represents a substantial cost savings.

Therefore, the loss of PF load even if it did occur, would not have to result in higher rates for BPA's PF customers and could actually result in higher BPA revenues if the resulting excess capacity were marketed within or outside the region at comparable or higher prices. Any remaining excess capacity could be used to reduce BPA power purchase costs by reducing the need to purchase higher cost power during winter peak demand periods. Bonneville's unwillingness to acknowledge these points is disingenuous at best and seriously biases its analysis of repayment reform.

Aluminum Price Assumptions

One of the most critical assumptions which BPA made in its analysis of the effects of repayment reform, concerns the future price of aluminum. For its "most likely" case Bonneville assumed that the average price of aluminum over the next 2 years would be 73 cents per pound. This is about 21 percent below current aluminum transaction price level of $.92 per pound.

Currently, BPA sells power directly to Pacific Northwest aluminum smelters under a variable rate which changes as the price of aluminum changes. The cost of electricity thus does not proportionately increase marginal costs of production if aluminum prices fall. The current variable rate charged smelters is 2.3 cents per kwh.

For its mid-range or "most likely" case BPA estimates the electricity rate would increase .8 cents per kwh to 3.1 cents per kwh. BPA implies that this price would result in a loss of 852 average MW of aluminum load and thousands of jobs. These statements by BPA are misleading and create an environment in which repayment reform will be critcized for seriously harming the economy of the Northwest. Bonneville's projections and statements about the resulting "devastion" to the regional economy caused by the closing of aluminum smelters are simply wrong because:

- Bonneville does not distinguish between the effects caused by the assumed low world aluminum prices and the estimated .8 cent per kwh increase in power costs. At current aluminum prices, repayment reform will not shut down aluminum smelter operations. BPA's conclusions about aluminum industry impacts result from the assumed lower aluminum prices not the resulting slightly higher power costs.

- If aluminum prices fell to the BPA assumed levels of 50 to 73 cents per pound, most smelters would shut down even without repayment reform. The U.S. capacity-weighted average cost of producing aluminum was about 60 cents per pound in early 1988 and, therefore, a 20 to 45 percent price drop will result in aluminum prices which are respectively below or slightly above the industry's average production costs. This will result in plant closings throughout the industry - with or without repayment reform.

- Repayment reform would have relatively small impact on aluminum costs. Repayment reform would have a 5 to 6 cents per pound impact on aluminum costs assuming (1) an average 7 to 7.5 kwh to produce a pound of aluminum and (2) the BPA rate increase of .8 cents per kwh. With aluminum prices holding over $.90 per pound for about the last 13 months the impact of repayment reform would be minimal. However, the rate increase assumed by BPA is in turn a function of the other pessimistic assumptions used in the "most likely" scenario. If the more realistic assumptions in the base case were used instead (see table 2) then the rate increase for aluminum smelters would be less than BPA's "most likely" assumptions.

- After several bad years aluminum companies had record profits in 1988. It is simply not credible for BPA to allege that a 5 to 6 cent per pound increase in costs will shut-down the Pacific Northwest's smelters at a time of record profits and prices.

- The power rates resulting from repayment reforms are below the rates BPA charged aluminum industry this past winter -- and no smelters closed during this period. During this past winter's cold weather, BPA had to curtail power sales to many of the aluminum smelters. During this period, in order to meet the smelter's needs, Bonneville purchased power and resold it to the smelter's at prices much higher (43 mills per kwh and above) than would result from repayment reform. The smelters did not shut down. In future winters, with BPA's excess capacity from repayment reform the smelters would not have to pay such high prices for power because they may not have to be curtailed by BPA.

- The effect of repayment reform on the 10 Northwest smelters would be about the same as the impact of proposed acid rain legislation on the 10 non-Northwest aluminum smelters which use coal generated power. It has been estimated by the Bureau of Mines that the effect of proposed acid rain legislation on the 10 non-Northwest smelters will increase costs an average of 2.5 to 4.0 cents per pound of aluminum. Some plants in West Virginia and Ohio could experience increases up to 7.7 cents per pound according to the Bureau of Mines. Is it fair for these smelters to compete against smelters in the Northwest which receive taxpayers subidized power?

- If aluminum prices did fall 20 to 45 percent as assumed by BPA, the direct service industry rate schedules could be restructured so that the rate effects on aluminum smelters from repayment reform could be minimized. With or without repayment reform the trend over the last decade of domestic aluminum smelters moving capacity to countries such as Canada, Brazil and Venezuela where electricity costs are 1/3 to 1/6 of those in the U.S. will continue with or without repayment reform. It is misleading for BPA to imply that the repayment reform proposal in the President's budget will result in the closing of Northwest smelters.

Interest Rate Protection Assumption

Because interest rates would be set annually Bonneville assumes it would need an additional reserve to protect against "interest rate voltaility". For the "most likely" case BPA assumes it would need an additional $100 million in annual revenue in FY 1990 and beyond. The additional revenue would be needed even if interest were falling. Because interest rates would be established at the end of the year and would be based on the previous 12 months rate it is unclear why such a large reserve would be needed, and why it would be needed each year. If the reserve were not used there is no need to continually generate more revenue each year than is necessary to cover costs including repayment to the Treasury.

Base Case Represent Most Realistic Assumptions

The assumptions used by BPA in its analysis of rate reforms are summarized in table 2 for the 3 cases analyzed.

Table 2

Current Actuals		Case 1 Base Case	Case 2 "Most Likely"	Case 3 Pessimistic
.95	Aluminum Prices ($ per pound)	$1	$ .73	$ .50
—	Interest Rates (% in FY 1990)	6-8	10.3	16
N.A.	Conservation (aMW)	172	197	535
N.A.	PF Load Switching (aMW)	0	300	500
	Aluminum Load Loss (aMW)	0	852	1,300
c2.3	Resulting Rate for Al Smelters (cents per kwh)	—	3.1	—
	Spot Price for Power Sales (cents per kwh) 1/	c2.68	c1.85	c1.39
—	Cost of Gas Generation in Calif. (cents per kwh)	c3.7	c2.6	c1.95
N.A.	Volatile Interest Rate	$100	$100	0
	Reserve (million additional $ revenue)			

1/ Does not include wheeling charge of about .1 to .15 cents per kwh or firm power sale which are generally at higher prices.

After evaluating the Assumption it is clear that the Base Case Assumptions are closed to current economic conditions and more consistent with assumptions in the FY 1990 President's Budget. For example, the current price of aluminum (transaction price) is about $.95 per pound.

Mr. CHANDLER. It is one of those issues that keeps coming up every year, and we, in the Northwest, circle the wagons and fight it off, and then it is always back again. I would like to see this one jettisoned for now.

Mr. DARMAN. Well, I can understand that from your perspective. It is a little bit like Mr. Gradison's perspective with respect to health-insurance coverage for State employees in Ohio. It tends to affect particular States and regions quite differently.

You would understand, of course, that here, from the perspective of a lot of people from other States, it is not entirely clear why people who are beneficiaries of the Bonneville system should be operating these many years since the depression at 2 percent, being charged 2 percent on their money, which is the rest of the country's money, while everybody else is being charged—as has been pointed out in several questions—a much higher rate in the marketplace today.

Mr. CHANDLER. Well, tell them we will start making airplanes out of cast iron instead of aluminum.

I would like to follow up with another question that concerns the repeal of the Airport and Airway Trust Fund tax trigger.

What this committee was trying to do with that measure was to say, if the administration is not going to spend the money—and it is about $900 million, estimated, for 1990, going up to $1.8 billion by 1993—on its intended aviation purpose, which obviously are a very high priority right now, that we should not collect it.

And I am wondering if there is not a third alternative, and that is to spend it for what the funds were intended. Go ahead and collect it, and use it to build airports, to build safety features for airports, and other purposes.

Mr. DARMAN. I think in our budget we propose to spend virtually every additional dollar collected for the purposes that you would have in mind. Although I am not sure, I think the increase is about $1.2 billion for FAA, most of which is for system improvement.

Mr. CHANDLER. Not for continued borrowing from the trust fund, which was done in the past?

Mr. DARMAN. Excuse me?

Mr. CHANDLER. It would not simply be borrowed, as the the Highway Trust Fund was reduced. The Airport and Airway Trust Fund was reduced as well.

Mr. DARMAN. I think the problem that you would be referring to goes to the question of what do you do with the unexpended balance, not what do you do with the new revenue that would come in. The unexpended balance is estimated to be $6.9 billion at the end of 1989; should that all have to go for capital expenditure immediately? And there, we would have a difference of view.

But certainly we think we ought to continue to have the revenue come in because there are system needs in the future that are going to depend on that revenue.

Mr. CHANDLER. Thank you, Mr. Chairman.

Mr. GIBBONS. Mrs. Kennelly, and then back to Mr. Downey.

Mrs. KENNELLY. Thank you, Mr. Chairman. Mr. Darman, last year, this committee spent a great deal of time on welfare reform. The bill went to both floors of the Senate and the House, and then to conference where a great deal of time was spent in negotiation for this entirely new welfare reform program.

I look in the Bush budget, and I see that the jobs part of welfare reform, an integral part of welfare reform, is not fully funded. I would like to know, if this a signal that we should take this to negotiation and have our budget people work it out, or in fact does the Bush administration not back us on this program that we passed just last year?

Mr. DARMAN. I believe that—perhaps I have my facts wrong—but I do not think so. I think that the program you are talking about, which is initially WIN/JOBS jobs combined, in the negotiated settlement was estimated to be at $800 million.

Mrs. KENNELLY. That is right.

Mr. DARMAN. And I think we have it funded at $350 million.

Mrs. KENNELLY. That is right.

Mr. DARMAN. And I think that there are two issues involved here, at least that I am familiar with. One of them is: Does the $350 million live up to the implied commitment. I would contend that it does because it is an entitlement program, and the question is what is expected to be spent?

The way the $350 million has been derived—as I understand it—is by taking the estimates from each of the 50 States as to how much they would spend under the program as you passed it, and as they understand it. You total all of that up for fiscal year 1990, and the number comes to only $350 million.

So we said, if that is their estimate of how much they are going to spend under the law, exactly as you intended it, then let's write it in at the $350 million, not at the $800 million, because it is an entitlement program.

The second question is: Are we trying to change it from an entitlement program to a discretionary program, as some people have said? As I understand it—though I was not party to the agreement—that would be a violation of the agreement.

No, we are not. All we are trying to do is cap the entitlement at $350 million instead of at the $800 million for this year, because of the reason I have just said.

I do not think we are trying to renege. It is just that when you passed it the estimate was that it would total $800 million, but now that we have all the information in from the States as to what they actually want to spend, it only totals $350 million.

Mrs. KENNELLY. Well, I was a conferee, Mr. Darman, and that never crossed my mind that this would be put in the budget that way. I come from Connecticut, and our commissioner was very involved in this welfare reform venture with the Governor of our State, and our State is ready to go forward with it as appropriated under the $800 million figure.

Mr. DARMAN. But they would get their full amount. You see, each State—yours, and a number of others that are ready, that are at the higher end—would get their full amount.

New York is another, I believe, that has a fairly high estimate. I think Massachusetts is also high. I have forgotten the specific States, but they would get their full amount—the exact amount they expected to get under the $800 million.

It is just that some other States have come in with very low estimates. It is not that it would be taken out of the hide of Connecticut or somebody else.

Let's put it another way around. If we write the number down at $800 million, they will not get any more just because they have come in estimating at somewhere near the full amount that they would be eligible for under the $800 million, applying the formula and the program as it is.

Mrs. KENNELLY. Well, thank you, Mr. Darman. I have to say, as a Congresswoman from Connecticut, I am relieved at that answer for Connecticut.

I would just like to say that the great deal of the time durng welfare reform was spent pushing and pulling to try to get other States that have poorer records around the Nation up to some kind of legitimate standard. So of course that does not help that.

But I still say I never envisioned that type of arithmetic.

Mr. DARMAN. But if they have not asked for the money we cannot send them a check and tell them to find some other purpose.

Mrs. KENNELLY. Yes, Mr. Darman, but I never would have imagined it.

Mr. Darman, another question. I listened to the conversation between you and Representative Matsui about forecasting, and I want to ask about that and the possibility—as we see already—that the Federal Reserve will raise interest rates.

They might have to raise them again because of inflation. And then let's look at the savings and loan plan. Every day, we hear that is possibly going to cost us more than was anticipated in the original Bush proposal.

Is there a place down the line where there is a possibility that we will bring some of that on budget—the solution to the savings and loan problem, because of the increased interest rate costs and since it will be more expensive off-budget?

Mr. DARMAN. Yes, under our proposal every dime in the interest cost we are scoring on budget. If there is a 100 basis point rise in the interest rate, there would be an impact that would be scored on budget, and it would have an adverse effect of about—a 1 percent increase is about $500 million a year, something on that order—$5 billion over 10 years.

But that would not be anything new. That——

Mrs. KENNELLY. That is in the original?

Mr. DARMAN. That is in our plan, not to have the interest rate rise, but if it did, the scoring is already contemplated in our plan.

Mrs. KENNELLY. So we really have a moving——

Mr. DARMAN. What we have told the banking committees we would do for them—and would be happy to share with you if you are interested, as well—is price the proposal under a whole bunch of other reasonable assumptions and see what effect that has. We will give them the data and see if it really makes a difference in terms of the way they would like to address the problem.

My personal opinion that is it will not change the way somebody would like to address the problem, but we are providing that alternative set of estimates to them, and can provide them to you as well.

Mrs. **Kennelly**. I commend you for that, because I think when we see the changes day by day, that we had better keep a very careful eye on it. Thank you very much, Mr. Darman.

[The following was subsequently received:]

Effect of Higher Interest Rates

Question:

What would the Administration S&L plan cost if your interest rate assumptions proved to be too optimistic?

Answer:

- If interest rates across the board and over the budget and planning horizon were 100 basis points over the Administration's estimates:
  - the cost of the plan would be $1.8 billion higher over the 1989-94 period and $5.2 billion higher over the 1989-99 period.
  - However, there would be near-term budget savings (about $400 million in 1990). Higher interest rates mean that the zeros bought to guarantee REFCORP principal could be purchased at a deeper discount. More premium income would therefore be available to the FSLIC Resolution Fund.
- If interest rates across the board and over the budget and planning horizon were 200 basis points over the Administration's estimates:
  - the cost of the plan would be $3.9 billion higher over the 1989-94 period and $10.7 billion higher over the 1989-99 period.
  - However, there would be near-term budget savings (about $700 million in 1990), due to lower defeasance costs.

Background:

- The attached summaries present the impact of interest rates 100 and 200 basis points higher than the our assumptions on the Administration's plan.

OUTLAY EFFECT OF HIGHER INTEREST RATES ON PLAN
SUMMARY
($ in billions)

3/1/89

	FY 89	FY 90	FY 91	FY 92	FY 93	FY 94	89-94	89-99
ADMINISTRATION PLAN	11.1	1.9	6.0	3.8	3.7	1.5	28.1	39.9
RATES 100 BP HIGHER	11.3	1.5	6.0	4.5	4.4	2.2	29.9	45.1
Change from Plan	0.2	-0.4	0.0	0.7	0.7	0.7	1.8	5.2
RATES 200 BP HIGHER	11.5	1.2	6.1	5.2	5.1	2.9	32.0	50.6
Change from Plan	0.4	-0.7	0.2	1.4	1.4	1.4	3.9	10.7

INTEREST RATES 100 BP HIGHER
COMPARISON WITH ADMINISTRATION PLAN
($ in billions)

3/1/89

	FY 89	FY 90	FY 91	FY 92	FY 93	FY 94	89-94	89-99
ADMINISTRATION PLAN	11.1	1.9	6.0	3.8	3.7	1.5	28.1	39.9
Change in Treasury Payment to REFCORP Interest	0.0	0.2	0.4	0.5	0.5	0.5	2.2	4.7
Change in premiums used for defeasance	0.0	-0.9	-0.7	0.0	0.0	0.0	-1.6	-1.6
Other changes (incl. FICO & FSLIC note interest)	0.1	0.2	0.2	0.2	0.2	0.2	1.2	2.1
TOTAL OUTLAYS: INTEREST RATES 100 B.P. HIGHER	11.3	1.5	6.0	4.5	4.4	2.2	29.9	45.1
Change from Administration Plan	0.2	-0.4	0.0	0.7	0.7	0.7	1.8	5.2

o REFCORP bonds, remaining FICO issues, and FSLIC notes pay higher interest.

o Cost of purchasing zeros to guarantee REFCORP principal decreases.

3/1/89

INTEREST RATES 200 BP HIGHER
COMPARISON WITH ADMINISTRATION PLAN
($ in billions)

	FY 89	FY 90	FY 91	FY 92	FY 93	FY 94	89-94	89-99
ADMINISTRATION PLAN	11.1	1.9	6.0	3.8	3.7	1.5	28.1	39.9
Change in Treasury Payment to REFCORP Interest	0.1	0.5	0.9	1.0	1.0	1.0	4.4	9.4
Change in premiums used for defeasance	0.0	-1.7	-1.2	0.0	0.0	0.0	-2.8	-2.8
Other changes (incl. FICO & FSLIC note interest)	0.3	0.5	0.5	0.4	0.4	0.4	2.3	4.1
TOTAL OUTLAYS: INTEREST RATES 200 B.P. HIGHER	11.5	1.2	6.1	5.2	5.1	2.9	32.0	50.6
Change from Administration Plan	0.4	-0.7	0.2	1.4	1.4	1.4	3.9	10.7

- o REFCORP bonds, remaining FICO issues, and FSLIC notes pay higher interest.
- o Cost of purchasing zeros to guarantee REFCORP principal decreases.

Mr. GIBBONS. Now Mr. Downey and then Mrs. Johnson.

Mr. DOWNEY. Thank you, Mr. Chairman.

Mr. Darman, I am delighted that you were selected Director of Office of Management and Budget, and I hope that does not hurt you.

I want to ask you some questions following up on what Mrs. Kennelly asked you about the $800 million, because this is a little different story than I think we have heard before.

You are basically basing the $350 million figure on what the States tell you they will be up and ready to do for jobs. So that if a State like Connecticut or New York is up and running, they will get what they would be eligible for if we had $800 million.

What if a State that has given you a lower estimate finds itself in a position to do more? Will they be able to get more?

Mr. DARMAN. Well, it is an entitlement program, and presumably—I mean, at least as I understand it—that is the agreement. It is to be treated as an entitlement program, and so presumably consistent with that, if they came in and actually could spend more money, they would then be entitled to it. There would have to be a supplemental.

Mr. DOWNEY. But you would not oppose a supplemental for States that decided to do more for this purpose?

Mr. DARMAN. If it were for this purpose, I would think if it is to be construed as an entitlement program in the spirit of your agreement, the answer is that you would have to have a supplemental go forward with it.

But at least for the time-being, we are saying let's cap it at $350 million.

Mr. DOWNEY. Well, my concern is that the States—as Mrs. Kennelly so eloquently addressed—have already come to see us saying that this is a reneging of responsibility here.

For instance, the Governor of Ohio said, look, we are ready to go, and as soon as the regs are promulgated, which hopefully will be in April, we want to be able to get moving. So——

Mr. DARMAN. I think it might be useful for us to work with you and your staff—following up—to try to see if we can get a clarification on this. We want to be sure that States that are planning as if it were $800 million, and moving as if it were $800 million, do not misunderstand and think that they have to plan as if it were a lower number.

They can keep moving forward. Let me make sure I am representing this correctly, because it is important, I think.

It is my understanding that that is correct.

Mr. DOWNEY. If it was not, it now is. Moving right along, President Reagan's budget assumed that HHS will collect $516 million in fiscal sanctions under welfare in fiscal year 1990, and these sanctions go back as 1981.

Do you also assume that you are going to collect this money, that I doubt is collectible, in your baseline? $553 million?

Mr. DARMAN. Yes. We make the same assumption.

Mr. DOWNEY. I think that is also a matter of ongoing discussion we would like to have with your staff, both because of the reality that the sanctions were not real to begin with, based on quality levels that I think are achievable now, have been achieved by only one State, Nevada, in the Union, and we would like to sit down and discuss with you some prospect of rebating possibly a large percentage of that back to the States, so that they can improve the administration of their own welfare.

But you have answered the question. I just do not think that that amount of money is there. You do not want to say anything on that, make any policy?

Mr. DARMAN. Well, what I was about to say was wrong.

Mr. DOWNEY. Today, the subcommittee staff has issued a report card, which I will forward to you, and I am sure you have lots of spare time to read it thoroughly. We are concerned about the dramatic reduction in the buying power of AFDC across the country. The value of AFDC benefits have gone down 36 percent since 1970.

Now, there are food stamps and other benefits to be added to that figure, but the report card graphically demonstrates an appalling lack of concern on the part of some States for the needs of their recipients. Can I ask you if we can talk, as a matter of policy here, whether this administration views with concern the varying levels of income support that go to children, let us say, in the State of Alabama or Texas versus those in Michigan and New York?

The first question is whether or not this is of concern to you; and, two, whether or not there are any plans or ideas to do something about trying to make the benefits better in lower income States for children?

Mr. DARMAN. Are you proposing to reopen welfare reform?

Mr. DOWNEY. No. I am asking the questions.

The question I asked you was: Are you prepared to do something about this? And is it something that is of concern to you?

Mr. DARMAN. Well, I think we would applaud the welfare reform compromise achieved through your able efforts and those of your colleagues, and we would like to try to live with that for a while.

As to the more general policy matter, if you carefully review my record, you will find I have been on all sides of this issue. [Laughter.]

Mr. DOWNEY. I am trying to get you on the right side of this for the hearing so I can hold you to it for some time. My time is up.

Mr. GIBBONS. Thank you. Now Mrs. Johnson, and then after that Mr. Pickle and Mr. Moody.

Mrs. JOHNSON. Thank you very much, Mr. Chairman.

It is a pleasure to have you here, Mr. Darman, and to have you in your current position. I commend you on your forthrightness and on your willingness to lay out your position and to recognize that, in the end, good law is made through negotiation. I do hope that we will all be capable of negotiating earlier rather than later. I do think it has implications for economic growth and for the productivity and quality of product for this Congress in many other areas outside of budget, as to whether or not we can make the difficult decisions that we are going to be called upon to make in this area early rather than later.

I also want to commend you on bringing in from your side the support for budget reform in response to an early question in our hearing today. In my estimation, that has been a very neglected area, both by the Congress and by the executive branch. I think it is critical that we force ourselves to use language that all members can understand and that our constituents can understand, because I think it is the only way that we can ever hold the process accountable.

And while it is neat to be able to go out there and talk about savings under current spending, it is not any kind of language that ordinary people use in their daily lives, and it is causing enormous confusion and, in my estimation, one of the things that is driving the discouragement of the public with the political process. So I hope that if we get to the point toward the end, as you mentioned in your remarks earlier, that if we get a package, that you would be willing at the end of that to look at both adjustments to Gramm-Rudman targets from the point of view of honesty and accuracy and budget reform. I think we have an opportunity to do some very important work together. So I thank you for that.

As to this issue of full funding of the jobs component of the welfare reform bill, I am very interested that you are saying that the States are asking only for $350 million, particularly in light of the fact that some States, including my own, are up and ready to go and can use their full allotment. Your comments indicate that there is a great disparity of State effort, and in our oversight work, we will be looking at this disparity of effort. It suggests that perhaps our controversy in the last Congress over participation standards—that is, compelling States to be willing to participate in the jobs program—was a debate that did not result in a satisfactory answer.

As an advocate of more forceful participation standards, I think the disparity of effort that is behind a $350 million estimate, based on State requests, is a very serious matter and will require our attention.

Three other comments. First of all, I cannot support your proposal to cut Medicare $5 billion. I hope you will take note of the resolution that now has garnered such broad support in the Congress that asks for a moratorium on cuts. I hope you will also take note that the moratorium is only for 1 year. I think it is imperative, and it is in terms of current reimbursement levels. Therefore, it is a modest initiative. It is not a radical initiative.

But unless we begin doing the research and developing the commissions that can look at what are the real cost drivers in Medicare, why do we have so little control over health care cost growth in America versus other nations, we will not be able to make responsible decisions about how to control Medicare cost growth, and we will continue to nickel and dime the system until we do to Medicare what we have already achieved in Medicaid; that is, to decapitate it as a program that provides access to health care for, in this case, the elderly. That has certainly been the consequence of our underfunding of Medicaid.

I think when hospitals are losing reimbursements on 50 percent of their Medicare patients, you are in big trouble. And that is why I am such a strong advocate of that moratorium, and I look forward to working with you on that.

I am sorry. My light has gone on, but I would like you at some point to address the issue of why it is you say we are freezing outlays, and others say we are cutting $20 billion out of the domestic side of the spending equation under Gramm-Rudman-Hollings. I think it is important that we are clearer about what those two proposals mean.

Thank you.

Mr. DARMAN. Thank you. Thank you for your introductory comments and the points about budget reform, as well, on jobs. Some of it may be disparity of effort, but some of it may be just a difference in the rate at which States can get moving. Some have been ahead of others to begin with, as you know. So I would not attribute it all to a disparity of effort.

On your Medicare point, it is another interesting point about language. One version of a freeze, the one that you like, would not cut Medicare as you say. Another version of a freeze, if you just kept the next year's level the same as this year's level, would, relative to current services, save us $13 billion—much more than the $5 billion. But the more serious point you raise involves the long term, and I would agree with you. None of us is yet adequately addressing the long-term issues in terms of what is happening to our health system. But I do not know anybody who has got a satisfactory answer on that subject.

We always say we need to do a more serious study, and we have been at this serious study for at least 20 years. I have not seen any closure on what the long-term answer is going to be.

Finally, on freezing outlays, if I could just suggest that you might take a look in my testimony at appendix J—not now, necessarily, but I would just refer you to it—you will see that category by category—defense and international and nondefense discretionary and the mandatory programs—there are actual increases in the outlays in every category. The only way that you get numbers that talk about cuts are if you compare fiscal year 1990 with current services rather than with the prior year. If you compare it with the prior year, in all the major categories there are increases.

Mrs. JOHNSON. Thank you.

Mr. GIBBONS. All right. Mr. Pickle and then Mr. Moody.

Mr. PICKLE. Thank you, Mr. Chairman.

Mr. Darman, years ago, back in the early radio days, we had a character that came on, Joe Penner. He always said, "Do you want to buy a duck?" I want to talk to you about some ducks you are trying to sell us here this morning. These are Darman ducks instead of the Joe Penner ducks. But I think they are much the same.

In your proposal here today, you have recommended some $36 billion in new revenues over the period of the next 5 years. I think you start off with $7.5 billion in 1990 and $10 billion the next year. Now, I am not talking about user fees or sale of assets and things like that. I am talking about $36 billion that are revenue raisers, that come within the jurisdiction of the Ways and Means Committee. Straight revenue raisers in one way of it, and you are proposing it, $36 billion.

Now, my question to you, then, would be: Why do you have revenue increases of this amount? Or do you call them revenue increases? Are they revenue raisers? What do you call them? Taxes?

Mr. DARMAN. Mr. Pickle, we call them more or less what they are. If you look at appendix C of my testimony, or you might have it in another form that you are looking at, we call them governmental receipts, and we have the numbers broken out for each year and under each category. We call each one what it is.

Mr. PICKLE. What do you call it, though?

Mr. DARMAN. Well, which one would you like to mention? The biggest piece of the revenue increase there, of course, is the capital gains issue, and I suppose some people would call that a tax cut.

Mr. PICKLE. Well, then, if you asked me to be more specific, you do not call that a revenue raiser?

Mr. DARMAN. It is under our estimate a revenue raiser, the capital gains shift. Some of these are revenue losers, like the child care tax initiative is a substantial revenue loser.

Mr. PICKLE. Well, let us take the example that Mr. Gradison raised earlier: Extending the Medicare payroll tax to all State and local employees.

Mr. DARMAN. Yes.

Mr. PICKLE. They are being asked to pay that. Now, is that a tax?

Mr. DARMAN. That would normally be considered a tax increase, certainly by those people. But the issue in defining a duck—which you were fortunately not burdened with, but I was for about 5 hours before I could get confirmed—one of the definitions of no new taxes said that if a tax had been previously proposed by President Reagan and then-Vice President Bush and had not been specifically renounced, it was not a new tax. And so this one, which is the health insurance tax, was previously proposed.

Mr. PICKLE. All right. Then you are saying that if we already have a tax and you just enlarge it, if you just enlarge the present tax, then that is not a tax increase?

Mr. DARMAN. Which one, sir?

Mr. PICKLE. I said any one of them.

Mr. DARMAN. I just did not hear. Did you ask about a specific one?

Mr. PICKLE. You just said, based on your definition, if it is already a tax on the books that it would not be considered a tax increase. I am assuming that you take the principle that whatever tax is in existence, if it just be added to, we do not have to call that a tax increase.

Mr. DARMAN. No, sir, that is not what I am trying to say at all.

What I was saying was that there were a set of proposals which are not now tax law, and which some people could legitimately call tax increases, but which President Bush is not saying are new taxes as he meant it, because he previously proposed them. That is all.

Mr. PICKLE. Let us take the case of the State and local government employees that Mr. Gradison raised.

Mr. DARMAN. Right.

Mr. PICKLE. Now, is that a tax increase against those employees in these States, Ohio and Massachusetts?

Mr. DARMAN. I think by ordinary language it would be viewed that way. Yes, it would. But it does not violate the no new tax pledge because it has already been proposed by President Bush before he ever said that.

Mr. PICKLE. And that is your explanation for why it is not?

Mr. DARMAN. That is not the explanation for the proposal. That is the explanation for why it is not a duck.

Mr. PICKLE. Well, what about the airport and airway trust fund?

Mr. DARMAN. Same.

Mr. PICKLE. You have the trigger. You want to repeal the trigger. And I raise this question because between the administration and House Appropriations, you are faced with a trigger that is going to go into effect this year because you will not release money to spend for cities, that need airports desperately, all across this land. And you all are locked into some kind of a budgetary squabble. Now you want to increase that tax. You want to keep higher taxes. Is that not a tax?

Mr. DARMAN. No, that one, I think, is a user fee.

Mr. PICKLE. Well, it looks to me like in some instances it is a duck and some instances it is not. And I would just say that it is whatever you want to call it, it looks like a tax to me.

Now, I guess my final question would be: If you raised $36 billion, and they are tax increases—no matter what you call them, that is what they are, period. If you raise that, why couldn't we just increase that amount in certain categories, in the same areas, and raise $60 or $70 billion? Would that suit you?

Mr. DARMAN. No, sir.

Mr. PICKLE. Well, then, what kind of ducks do you want us to buy, then?

Mr. DARMAN. Well, preferably ours.

Mr. PICKLE. Do you have some suggestions for us what might be——

Mr. DARMAN. Yes, sir.

Mr. PICKLE [continuing]. What kind of ducks would be revenue raisers?

Mr. DARMAN. None. I have some suggestions for some excellent revenue raisers I would recommend for your serious attention. They are at appendix C.

Now, you may have alternatives, I know, because some of these are not viewed too favorably by this committee. But you asked a different question, or at least two questions. You asked could we have double the amount, and I am saying that I do not think so because we do not feel you need it in order to achieve deficit reduction. We do not think it would be economically desirable to achieve deficit reduction that way. We do not think that if you said you were going to do that you would actually end up with the savings. But, in any case, with respect to particular items, you think it will turn on a case-by-case judgment. There is not a single, absolute rule.

As you are pointing out, we have got a bunch of specific proposals here, and we could quibble about which ones should be called what. But, in the end, it is not going to turn on what we label it; it is going to turn on whether we agree on the substance of the proposal.

Mr. PICKLE. Well, Mr. Chairman, I will just conclude by simply saying that there is nothing magical about your $36 million, and if we were to increase those, we would just be playing the same game you are. And I do not think you are being honest when you say they are not tax increases, but I think the public understands that. It is a matter of nomenclature or whatever definition you give to it.

We are faced with the real world up here. What are we going to do, and where are we going to get the revenue?

Mr. GIBBONS. Mr. Moody and then Mr. Coyne, and then after that Mr. Jenkins.

Mr. MOODY. Thank you.

Welcome, Mr. Darman. We all welcome your candor. It has certainly been your hallmark since you have been in this job, and I think we have all appreciated it.

I think you would agree that one of the main things we have to do here in Congress is come up with a game plan that has credibility to the market. I mean, one of the main constituencies out there for us all, Mr. Darman, is the financial market, the international financial market.

How credible is it if we use economic assumptions which have been branded as totally unrealistic by a series of economists who have sat in that very chair and have come before this committee? We have not found one economist who can tell us that in 1990 we can expect simultaneously a 3.5 percent growth rate in the economy, 5.5 percent 30-day T-note rates, and a falling rate of unemployment. Those are not mutually consistent internally. It has nothing to do, according to these experts, with the prompt or nonprompt enactment of the budget, which has been used as the linkage or the explanatory variable here. No matter how promptly or unpromptly we enact the budget, you simply cannot get those three sets of numbers working simultaneously, and the deficit is quite sensitive now to some of those numbers. So you cannot have it all three ways at once.

Do you want to comment on that?

Mr. DARMAN. Yes, sir. One, it used to be conventional wisdom that you could not have unemployment coming down and inflation coming down and a consistent long pattern of real growth, real growth going up. But for most of the last 6 years, we have had exactly that pattern. Interest rates have been falling sharply; inflation has been falling——

Mr. MOODY. Real interest rates have not been falling.

Mr. DARMAN. No, not real interest rates. They have varied over the period.

Mr. MOODY. Well, a 5.5 percent nominal interest means there is going to be a fall in real interest rates unless you want to see inflation go to practically zero.

Mr. DARMAN. Well, our inflation numbers are normally challenged as well. That is the point that I was trying to make before; that if we are wrong on the interest rate, we are also probably wrong on the inflation rate. And the combination of the two will not affect the deficit very substantially. If we are wrong on both of them, if both of them should be higher, the deficit effect is not substantial.

We would be happy to provide you with different sensitivity runs on this. I do not think you will find that they can fundamentally affect what you are going to want to do about the deficit.

The real difference, I think, is not the short-term difference. I mean, the difference starts to get large among economists with respect to the out-years. That is where the big difference is, and it is a difference about what is the long-term sustainable real growth rate. And you can get divisions. It is not zero in our camp. There are a substantial number of economists in our camp.

In fact, our assumption is consistent with a 40-year trend line, and the people who are arguing it has got to be lower are people who are saying there is some inherent reason that American productivity has to be lower than it has been in the past and cannot return to its trend line. We do not agree with that. We think we should adopt policies that increase productivity.

Mr. MOODY. Of course. I was not arguing the point that you answered. I would say that you cannot have 5.5 percent nominal interest rates and 3.5 percent growth rates simultaneously. You just cannot do that, I do not think, in anyone's judgment, regardless of what happens to inflation. I mean, this is 3.5 percent real growth rate.

Mr. DARMAN. I think you have the chairman of the Council of Economic Advisers, Michael Boskin, coming before you. I do not defend any particular forecast because I do not think the science is up to any of this. I defend the more common sense approach to direction. And is it reasonable to think that we can get the direction of interest rates coming down relatively sharply if we reach an agreement? Yes. All the way to the levels that are specifically in our forecast, or quite as fast as is in our forecast? That is highly arguable.

Mr. MOODY. Let me move to a related point. Those interest rates are going to be sensitive, obviously, to the total amount of borrowing that takes place in our society from the public or quasi-public sector. If we move the S&L bailout or remedy off budget, as the administration is proposing to do, that is still going to be competing for the same fixed supply of loanable funds. It seems to me we might be better served to keep it on budget, and adjust the Gramm-Rudman targets explicitly for that specific reason. The market may treat that as a more honest exercise in keeping it off budget and meeting the Gramm-Rudman targets with that off budget, but still out there competing for the same supply of loanable funds and driving up interest rates and creating the kind of pressures on capital markets that we are trying to avoid.

I mean, the Gramm-Rudman targets, if they were adjusted explicitly for this purpose, it seems to me it might be a more honest exercise. And the market factors you cited answering some earlier question seems to me would treat that as a more honest exercise than moving it off budget and meeting the nominal targets.

Mr. DARMAN. Well, we actually treat everything that should be on-budget as on-budget. So I would quibble with you a little bit on the characterization. The only piece that is off-budget is the obligation to repay the principal, which is fully covered by privately purchased Treasury zeros. So the Federal Government has no obligation whatsoever with respect to those. So I do not understand why that should be on budget.

Mr. MOODY. Well, you admitted earlier that there would be up to 25 basis points higher price of the cost of money.

Mr. DARMAN. No. What I said was that it would be a 15- to 25-basis point spread in terms of those 30-year bonds versus 30-year Treasuries. But you are not going to finance with 30-year Treasuries alone. You are going to finance with a mix that averages in maturity about 6 years. The average maturity at 6 years is trading about 20 to 25 basis points above the 30-year Treasuries. So the difference, the actual difference in financing it with Treasuries versus financing it the other way might be zero, even though the spread on 30 year Treasuries and bonds would be 15 to 25 points different.

Anyhow, your point is a different one—what to do about the Gramm-Rudman-Hollings treatment of the S&L issue. There, my point is this: If it were such neat surgical exercise that you could simply come in and amend Gramm-Rudman-Hollings for this very limited purpose, then you might not have any significant adverse market effect, if it understood it exactly. But there is no chance, particularly on the Senate side, of any such a neat surgical exercise. They do not have the ability to control the floor with a rule. What will happen is that Gramm-Rudman-Hollings will start to come apart, I think, on the Senate floor because people are going to have all kinds of amendments, at which point who knows what we have got in the end. If we reopen Gramm-Rudman-Hollings before we have done anything to reduce the deficit, I think that would be a terrible signal for the markets.

Chairman ROSTENKOWSKI. Mr. Coyne will inquire.

Mr. COYNE. Thank you, Mr. Chairman.

Mr. Darman, one of the primary reasons that was advanced by the administration to reduce the capital gains tax was to enhance investment and, as a result, enhance our competitiveness. Since only 30 percent of capital gains is due to industrial investment, and the remainder is due to real estate gains and other nonindustrial investments, why do you propose to reduce capital gains.

Mr. DARMAN. But those are the investments that are most likely to have a favorable effect on our productivity growth rate. What really should matter to us is getting that productivity growth rate up high. Any incentives we can structure to increase the kinds of investment that will, in the long term, improve our productivity growth, will increase the chances of our being able to get back on our historic real growth path and increase the chances of all the benefits that come with that additional growth.

But it has got to be investment that increases productivity, and I think that what is excluded under this proposal—to put it the other way around—intends to focus the benefit on those investments that are likely to have the most favorable effect on productivity.

Mr. COYNE. But it appears to me that if 70 percent is nonindustrial investment, then the reasoning for a capital gains reduction does not hold the weight that the administration has proposed.

Mr. DARMAN. Well, if you are referring to real estate, though—is that the main thing that you have in mind?

Mr. COYNE. Well, real estate and——

Mr. DARMAN. That does not get the proposal rate reduction because it is depreciable property.

Mr. COYNE. And other nonindustrial investments.

Mr. DARMAN. Collectibles are also excluded. I mean, we would all agree, probably, that creating an incentive for people to invest in art and things like that is not going to increase productivity. It may have other merit, but it is not going to increase productivity a whole lot. So the question then turns on real estate, and I think most people would argue that America already has an enormous set of incentives that favor investment in real estate. Part of our problem as a society may be that we over—I should not say this. What I should say is that we have already got very strong incentives for investment in real estate, and there is no evident need to increase that. There is apparent need to increase investment in things that will improve our productivity.

Mr. COYNE. And so it is worth it even though it is only 30 percent in the case of industrial investment.

Mr. DARMAN. It is clearly worth it in the long term if it produces the productivity gain.

By the way, I would emphasize that none of the benefits of productivity gains are reflected in the revenue estimates. The real gain from capital gains is not what you get in the short term from unlocking assets that reflect investment already made. The real gain that you should care about is the gain that comes from increased investment in the kinds of things that ultimately increase real economic growth and produce a higher level of GNP than you would have had otherwise. Those gains are not reflected in either our estimates or in the Joint Committee's estimates, but they should be.

Mr. COYNE. On another subject, at your confirmation hearings, you indicated that if you were only to change the forecasts of the administration by a very minimal amount, that it might not be worth the realization that would come from that change. And I just wonder how much confidence you have in the new adjustment that has been made relative to the forecasts that are in the Bush budget.

Mr. DARMAN. You mean the one that we made?

Mr. COYNE. That is correct.

Mr. DARMAN. Well, that was not really an adjustment of a forecast. That was an adjustment for reality. Part of what had been forecast was the first 4 months of fiscal year 1989, and those had already taken place. And what we really did was we simply reflected the fact that the old forecast was wrong for that set of months, and we adjusted for reality. We did not really change the long-term forecast. We are not going to reassess the long-term forecast until the midsession review.

Mr. COYNE. The issue of sequestration, it appears that many of the domestic programs would come out much more favorably under a sequestration order. I just wonder what incentive the Congress has or those of us who would not want to see domestic programs cut, what incentive do we have to negotiate an agreement other than to go to sequestration?

Mr. DARMAN. Well, I think that for domestic discretionary programs—from the numbers that we have, which we would be happy to provide for the record—under sequestration they would get $178 billion and under the proposed Bush budget levels they would get $182.4 billion. They would actually come out slightly over $4 billion better under the Bush budget than under sequestration.

The domestic discretionary programs are hurt substantially by sequestration. What tends not to be hurt by sequestration is what the chairman was referring to before, and that is programs like Medicare relative to what was proposed in our budget. But the domestic discretionary programs—drugs, education programs, a number of the research programs, the airport programs that people have been talking about here, a lot of the programs that people care about on the discretionary side, even some of the farm programs--notwithstanding the option 1 treatment of some of them, many of them would come out better under a Bush budget than they would under sequestration.

We can give you a breakout of that if that would be helpful to you.

The burden of sequestration falls heavily on defense and heavily on domestic discretionary programs. The programs that tend to get exempted are entitlement programs and means tested entitlement programs. We have essentially spared all of those from cuts with one exception in the Bush proposals, and that is Medicare. That is where there is a significant difference that favors Medicare if you go with sequestration.

Mr. COYNE. Thank you.

Chairman ROSTENKOWSKI. Mr. Jenkins will inquire.

Mr. JENKINS. Thank you, Mr. Chairman.

Mr. Darman, I want to thank you for including the R&D tax credit in the President's proposed budget. I think it should be made permanent so that there can be some stability to become more competitive worldwide.

But I want to ask you about an area that concerns so many members of this committee: Medicare reductions. Under part A where you have capital at 75 percent of cost allocation, update PPS rates by hospital inflation minus 1.5 percent--each of those have substantial revenue figures.

Those reduced reimbursements would not necessarily adversely impact the Medicare recipient under part A. Is that correct?

Mr. DARMAN. Yes. I think that is right. It is not intended to affect the Medicare beneficiaries adversely.

Mr. JENKINS. But in fact, of course, as far as the patients who are not Medicare recipients, their charges would have to go up. Isn't that basically correct or the income of the providers would have to be down relative to what it would have been otherwise?

Well, the problem is that in my district, we have a multitude of hospitals that are either closing or are on the verge of closing simply because they cannot survive under the existing reimbursement rate, and basically what we are doing is further impacting them, correct?

Mr. DARMAN. In the case of some particular hospitals, that is bound to be the case, Congressman Jenkins, but I am not sure that it splits peculiarly by type. In other words urban versus rural; to the extent that you thought that it did, obviously you could make an adjustment in the split of the burden.

Mr. JENKINS. I have been meeting with the hospital boards in the 22 counties that I represent, and I must tell you that every single hospital without exception is having very deep problems in trying to survive, and some of them are going to close, I know that. It appears to me that with the further restraints, the situation is going to be exacerbated.

Part B affects the Medicare recipient directly. You are recommending that we freeze nonprimary physician charges for 3 years.

Is that basically what we are doing so that their prevailing charges could not go up in the next 3 years?

Mr. Darman. It is only frozen for the first year, and then it goes up at a lower rate—1 percent per year in 1991 and 1992.

Mr. Jenkins. Only because it goes up 1 percent?

Mr. Darman. Right.

Mr. Jenkins. It sounds like a freeze to me.

Mr. Darman. It is close to a freeze.

Mr. Jenkins. Now that simply means that the physician will—or can—pass that on to the patient. Is that correct?

Mr. Darman. Just 1 second.

Well our proposal did not specifically address whether there would be a change in the so-called back limits or not, and how much of that could be passed on or not. But it seems to me that the intent of the proposal ought not to allow it to be fully passed on, that some of the burden should be borne by the provider.

Mr. Jenkins. So, the administration is going to recommend that the physicians be prevented from passing on?

Mr. Darman. In my understanding—that is not in the proposal, so let me just say we will have to take a second look at that.

As it has been submitted to you we are silent on that point.

Mr. Jenkins. I think that is a very important point. Let me ask one question regarding catastrophic health insurance. Every member, I am sure, has received hundreds of letters from people who feel that they are being unfairly treated under this program if they already have identical or similar coverage, and they do not need the catastrophic.

Is the administration going to make any recommendations in that area as to a modification of the premiums?

Mr. Darman. No, we are not. We are proposing to continue the existing and recently enacted system.

Mr. Jenkins. Thank you. My time is up.

Chairman Rostenkowski. Mr. Andrews will inquire.

Mr. Andrews. I would like to direct your attention, Mr. Darman, to another subject that we have not talked about this morning, and that is the space program.

It seems like we really have two goals here, one to meet the budgetary constraints that we work under and at the same time to have an aggressive space policy.

One of the ways to get there is privatization and commercialization of space, a goal that was important to the Reagan administration as I know it will be important to the Bush administration.

One of the proposals in your budget is the privatization through the financing mechanisms of seven separate portions of the space station.

Now in reviewing these and talking to people from NASA and industry, the people who deal with NASA, I cannot find any overriding commercial strategy here. In fact what I have been told from others is that what we are dealing with are not decisions designed to help commercialization of space but rather budgetary decisions. This would be the worst thing for us to do right at the time when we need to develop a commercialization strategy and to have them driven not by budgetary decisions but rather by really space policy decisions.

Let me give you an example briefly. I do not know how familiar you are with each one of these different provisions but one of them is the telerobotics servicer. That is a big arm that is going to stick out from the space station and enable astronauts to do maintenance on the station and experimental work outside the station without having to physically leave the confines of the station itself.

You propose in your budget that this $30 million project—and incidentally one that will be very important early in the space station design—be financed by private industry. I can find no one that thinks this is a good idea. In fact most of the people that I have talked with are extremely concerned that what we are doing here is getting private industry involved in an area that private industry will not want to use. In fact the only real user will be NASA itself.

I guess the question is what kind of policy is this? There are seven different items of space station design that you have moved out of the budget and asked private industry to finance. Have these decisions been done because of budgetary reasons alone, or is there some overreaching space commercialization policy here that I have not seen yet?

Mr. DARMAN. I cannot speak to those specific financing proposals. We essentially have incorporated the prior proposals by reference under that heading. In other words we chose not to change the Reagan administration's review of that, and not having participated in that I do not know what the logic was—whether it was related to space commercialization or whether it was a budgetary decision.

In trying to get all of this done by February 9, the big issue we had to was face the overall level of funding for space programs, given all of the competing claims. If you look at the very large increase in investment for space—$2.4 billion in 1990 over 1989, that we have proposed—the question should be whether we can afford that big increase? The most important element of that question was the space station itself and whether one wanted to end the aggressive launch schedule.

Those were the issues addressed specifically by President Bush when he decided in favor of continuing to move toward manned space station as rapidly as possible, and an aggressive launch program.

We have not looked at these relatively smaller budgetary issues. The ones that we looked at were $2.4 ~~billion in~~ scope, and we did not get down to the financing ones.

I would say that on commercialization, more generally, I think that we made a move in the mid-1980's to commercialize some of the launch elements of space, but we are still slow as a society in getting to where we have figured out how best to commercialize activities in space. And I am not familiar with these particular financing proposals, but the more general issue of coming up with a more coherent strategy for commercial activity in space. Industrial and other activity in space—that strikes me as very important, and something which has been underattended to by the Congress. The Reagan administration made an attempt at commercializing activities in space, but it was somewhat aborted at the end of the administration.

Mr. **Andrews**. I want to ask you to revisit this with your staff and take a look at this. I have also asked the head of the space station a week ago to define for me how these seven different items were chosen for commercialization. I agree with you—these are not the big ticket items that you have been dealing with or that we have been talking about today, but they are critical if we are going to have a strategy for space commercialization.

Earlier, the head of the space station could not answer my question as to whether these commercialization projects related to a space commercialization policy or whether they were simply budgetary decisions that were being made in order to try to meet the Gramm-Rudman targets, and I would hope that you would take time to look into this.

Mr. **Darman**. It would seem that. I have not looked at the specific elements, but it would seem that a question you have to ask yourself is are these elements going to have a continuing demand in space? Is it going to be a going business, and is it likely to have any growth potential?

Mr. **Andrews**. Absolutely.

Mr. **Darman**. And if the answers are yes, then it probably does make sense to try to encourage private entry as fast as you can.

Mr. **Andrews**. Absolutely.

Mr. **Rangel** [presiding]. The time of the gentleman has expired, and it is time for another gentleman to inquire.

Mr. **Levin**. I would yield whatever part of my 5 minutes.

Mr. **Andrews**. Thank you.

Just to finish up, you are absolutely right, and I am suggesting to you that most of these items, through testimony and hearings and documents thus far do not answer in the affirmative to your question, and I would ask that OMB revisit these items and their relationship to the broader issues of space policy.

Thank you.

Mr. **Levin**. In the education field, what would outlays work out to be under your proposal compared to the original budget in the previous year?

Mr. **Darman**. That is a pretty abrupt change from the space program.

Well, for total education—Department of Education discretionary programs in 1989 was $16.3 billion in outlays and under President Bush it would be $17.1 billion in outlays.

Mr. **Levin**. And that is $17.1 billion for the next fiscal year versus $16.3 billion this year, right?

Mr. **Darman**. Right.

Mr. **Leonard**. And under the Reagan——

Mr. **Darman**. In outlays, under Reagan it was $17 billion for total discretionary education.

Mr. **Levin**. Now this could be affected by the decision on items in the so-called black box, right?

Mr. **Darman**. Right. It is affected by decisions on both the priority preferences and items in the black box.

Mr. **Levin**. Right.

Mr. **Darman**. There are education items in both categories.

Mr. **Levin**. So, the figure $17.1 billion could be somewhat decreased or dramatically increased depending on what we did with—for example, compensatory education.

Or to put it another way——

Mr. **Darman**. It depends on what you do with all of the education programs. If an area that increases is off-set by an area that decreases in education, but the net is the same, obviously the total will be the same. But if the education increase is offset against a decrease somewhere else in a noneducation area, then net education is going to go up.

Mr. **Levin**. So, if you assume a freeze, the outlay figures differ item to item because of decisions made earlier, the impact could vary considerably from program to program, right?

Mr. **Darman**. That is only if you did a freeze on budget authority. If you freeze outlays, which is one of the options we have presented—if you freeze outlays, then the outlays stay constant, but the budget authority has to vary.

Mr. **Levin**. OK.

Let me just ask you—how does it make sense—except politically—for the Executive—I do not care if it is Democratic or Republican—to present a budget and essentially lump together way over $100 billion in programs, and say to the Congress "we are not recommending priorities. It is up to you and us together?"

Mr. **Darman**. We have recommended priorities—excluding interest—for something approaching $900 billion. So it is not as if we—I mean we have addressed 88 percent of the budget—including interest—and the $136 billion that you are referring to that remains is 12 percent of the budget—it is not exactly an overwhelming portion of the budget for which we have said simply that we are prepared to negotiate.

We have our own preferences, and we have been willing to state them.

Mr. **Levin**. But they are not outlined item by item in your proposal.

Mr. **Darman**. We have since submitted 4,000 some odd pages of line by line data on every one of those lines in the $136 billion, and for each of them there are three options, one of which is the Reagan proposal in the discretionary accounts.

In most cases, that is what is being defended as the official position. When you ask how can you not recommend priorities—the implication is that this is not fulfilling a responsibility.

The alternative I would note—the historical record on the alternative—is to write down proposals which last less than a day. They go nowhere. They have gone nowhere. They have gone into a wastebasket at their best.

It is very difficult for me to understand why that would be judged to be reasonable and why proposing to negotiate about these would be judged to be unreasonable. In the end what happens is that we negotiate, and what we are saying is that given the urgency of the matter why don't we start by negotiating.

Mr. **Levin**. My time is up. We are not going to resolve this here, obviously. It has not been that each of the priority proposals of the Executive have been thrown into the basket. Maybe the overall product has because it was built on sand, but at least we had from-the Executive its prioritization as to each item, each important area in the budget.

We do not have that from you.

Mr. DARMAN. The appropriators all do have now our position on every one of these for purposes of starting the appropriations process.

Mr. LEVIN. In the alternative——

Mr. RANGEL. Mr. Guarini may inquire.

Mr. DARMAN. No. They have what is generally option one.

Mr. RANGEL. The gentleman's time has expired.

Mr. Guarini.

Mr. GUARINI. Thank you.

Dick, over the past few weeks you have answered every possible question concerning the budget, I imagine, and you are very articulate, and of course you have refined those skills.

I would like to ask you a few questions on vision and leadership. We are generally concerned that the administration is in a campaign mode, and has not used the honeymoon for defining the vision of where we are to lead the Nation.

We have a need for strong leadership and strong vision. The National Economic Commission missed a great opportunity that turned out to be a false start. The programs and priorities that are set forth in the black box certainly is not leadership. It is just a little bit of this and a little less of that.

And when we talk about the safety net which we are supposed to have put in place, there are more homeless and less housing than ever before.

So instead of talking about the big numbers, let us talk about philosophy, and where we are going as a nation. It is very difficult to feel that there is a clear vision of where this Nation is going.

Let me ask you hypothetically on sequestration. If the black box solution is not accepted, and we end up in sequestration, which is something I think would not be be a very good idea, but if we did end up in sequestration—which is beginning to look more attractive than ever before to some people as an alternative, or at least have a budget that would deal with sequestration if not kicked in by the President automatically under the Gramm-Rudman Act—and you were forced to advise the President, or the administration had to take a stand as to whether or not to seriously cut the defense budget or to have new taxes put in place, what decision would you make?

Mr. DARMAN. I would favor sequestration, but I am not speaking for the President. I am speaking for myself. I cannot say what he would say because it is a hypothetical and it would depend importantly on events that have to take place between now and then. Who knows what the state of international tension may be or not be.

Mr. GUARINI. But we may get to the point, of course, of choosing between one or the other, and you are an adviser to the President, and he sits and listens to you in regard to budget matters.

Now you can see, then, that there could be a very clear scenario that the President has to decide between cutting the budget considerably under the Gramm-Rudman, or have new taxes that he would go the route of cutting the budget considerably?

Mr. DARMAN. That would be my expectation, but I cannot speak for him on that, and I am speaking for myself.

My advice is that if the world is then the way it is now, I would recommend that he take the sequester.

Mr. GUARINI. All right.

Let's talk about vision and leadership of the Third World debt.

We know that when we read everyday that a solution is needed very badly. It affects our trade, it affects the stability of the economy globally, and it has a pronounced influence on where we and our allies are going as far as trade, commerce, and economic stability is concerned.

Where in the budget, considering the importance that we have in solving our Third World debt, is there any reference as to how we are going to approach this problem which is immediately upon us?

Mr. DARMAN. No, there is not any reference to that in the budget per se, although obviously it is framed in terms of Third World debt. Obviously there is a request to fulfill our outstanding commitments, which are in arrears, to fund the multilateral development banks—this is an important piece of this issue.

Mr. GUARINI. And that is going to cost us additional moneys?

Mr. DARMAN. That will cost additional money, and to fund some more ambitious programs—that some have mentioned—would mean that you would have to trade that money against people's willingness to invest in resolving the S&L crisis or doing other things domestically. I do not think our political system is likely to decide that it wants to——

Mr. GUARINI. If you had to chose between having a resolution for the third world or making other cuts domestically, you would choose domestic cuts?

Mr. DARMAN. No, I do not believe that we have that choice. I do not believe that that choice is required.

We have proposals in there to fund the multilateral development banks, and the next stage of the debt strategy is going to have to rely heavily on the international institutions. All we are asking is that we fulfill our existing commitment to those institutions, and from there the question is what policies they follow to help move the debt strategy to the next stage.

Mr. GUARINI. But it is going to cost considerable moneys, and we are not really addressing ourselves to that as far as leadership is concerned as well as Central America where we have the Kissinger and Sanford report where we know we are going to have to invest considerable moneys in the economic stability of Central America.

Is this another area that that budget does not address?

Mr. DARMAN. I have not agreed with the prior—you did not ask me to comment on your introductory statements, so I refrain from doing so.

Mr. GUARINI. Unfortunately, we have a limited amount of time in there.

Mr. DARMAN. Well, could I note that I did not——

Mr. GUARINI. There are a lot things that I would like to know where the division is concerned in this budget.

Mr. DARMAN. You did not ask that, but you just commented saying that it was not just there, and I did not respond. But I think that we have tried to give a very heavy emphasis to investment in the future, research and development, education, although in education it is not with funding but with a difference in approach.

But I would grant the point that there is so much left over from the past that there is a very limited amount of resources available at this stage. If you want to solve problems of the size of the S&L's and the atomic weapons cleanup, and you want to get a deficit down from $170 to $100 billion in a single year, you are obviously constrained in what you can do in the short term. Over the long-term what I think you should be looking toward from us is more and more emphasis on tilting the budget toward the future—to try to increase our productivity gains in the future to try to increase the quality of human capital available to work in a rapidly changing world on a competitive basis, to restore U.S. competitiveness, et cetera.

The initial steps in that direction I would grant you are clearly small at this stage. But we first have got to get our house in order, and I would respectfully differ on the question of whether what we are proposing would do that. I believe that it would move us a very long way toward restoring fiscal balance. Once we have done that in a way it could contribute to future growth, then we can have more room for more interesting initiatives.

Mr. RANGEL. The time of the gentleman has expired.

Mr. GUARINI. I just have one final question, Mr. Chairman, if I could follow up.

If we know that we have fiscal problems ahead, and that we do not have enough money for nuclear waste disposal and savings and loans, and all the other Third-World debts and Central America economic stability, and all the other things that you have mentioned.

If we do not have the prosperity, if we do not have the continued growth that is projected in the budget, does the administration have a contingency plan in case there is a recession?

Mr. DARMAN. Not a formal contingency plan, but I would differ again with the hypothetical. We have funded in the budget what it takes to solve the S&L crisis. We have funded what it takes for the next 3 years to handle the atomic weapons cleanup. The out-years beyond that are probably underestimated.

But at least for the next 3 years, it is funded at as high a rate as anyone seems to suggest is appropriate, or just about as high. And so on down the list.

So, we have taken a big step forward with respect to a lot of these, which is why there is a rather limited amount of money available for some other things.

Now, the direction of this argument tends to go, well, then, why do you not raise taxes if you can think of all of these other interesting things to do?

I think enough has already been said on that subject, but if the question is, if there is a recession, would we propose to increase taxes? I would think that for all the conventional reasons, the answer would be no.

Mr. GUARINI. No matter which way you would go?

Mr. RANGEL. The time of the gentleman has expired.

Mr. GUARINI. My time has expired. Thank you.

Mr. **Rangel**. Mr. Darman, the kindest thing that I could say on your appointment, I wish you were on our side, but it bothers me to see how loudly I applauded the President's message because it seemed as though he had pushed all of the buttons that concerned the programs that I have supported over the years in the Congress, except after I received the document, it seems as though in these very same areas other cuts have been made.

Now, I know that you just deal with the dollars and cents rather than the sense of the program, but I wonder whether or not it your office's responsibility to calculate the actual losses and productivity and foregone taxes as a result, say, of the increasing dropout from high school, a subject matter, related to the President's desire to be known as the educational President.

Or the reports that have been drafted by Stu Eisenstadt and Jim Cannon. Their figure on productivity losses from dropouts is $340 billion a year. They also note we spend $6 billion a year just in our prison system. That does not include the local and State criminal justice system.

I understand that is $17 billion a year that we involve just taking care of the babies that are borne by teenage pregnancy. It is my understanding that the relationship between the increase in the kids that are dropping out of school and homelessness and welfare hotels, substandard housing, couple the dropouts with that and you find yourself in high drug addiction areas, increase in crime, increase in services that are needed.

If you constantly find that these numbers are increasing in what we have to pay in the end, and find that on the front end the President talks about supporting the McKinney Act, and then there are no provisions for low-income housing or mortgage revenue bonds, the President says he wants to target at-risk kids that are dropping out; then, the Department of Education shows substantial cuts have been made in this very same area, and then, of course, when the President said he was asking for $1 billion for the war against drugs, and then the Budget Committee comes and they find that they are $1 or $2 billion short of what was authorized by the Congress.

My question really is, and I hope you can send me the specifics, since we have a time limitation, is that, has your office ever taken a look at what we have to pay in the long run for doing nothing? Is it your office that might study the relationship of what we are paying out for the high school dropout? For the increase in teenage babies, for the hospital care for addicts and treatment, for the prison system, rather than concentrating and providing those services in the front end? That is, decent homes, decent training, keeping families together, and keeping kids in school.

Mr. **Darman**. Thank you, Mr. Rangel.

Normally, our office would look at such issues with regard to particular programs and would rely on the agencies' studies or the agencies contracting with outsiders to do the studies.

However, I have said that I would like to see OMB get more involved in larger issue analysis of this type, and other types, particularly oriented toward looking across a range of programs and across time.

I would be very interested to have us try to pull together something on this. I do not think it could be done all that quickly. It probably cannot be done in a responsible way until the next budget cycle, but it is the kind of thing that I would like to see us do more of.

If you are really serious about what I just said earlier, investment in the future, trying to tilt the budget more toward investment in the future, you have to look at some of these programs—especially human capital programs as investment issues, not just current consumption issues.

I know that is kind of a cold word for what you are talking about, but it——

Mr. RANGEL. No, it does not bother me at all.

Mr. DARMAN. But, analytically, it is, in my opinion, the right way to look at these issues.

Mr. RANGEL. If you could begin now, in just determining the course, how much we are investing in individuals that we have profiles on, as to what kind they are going to cost society—and I am not talking about productivity, I mean actual costs in treatment, jailing, where they say it costs them $20,000 to $30,000 a year, just to keep them in jail; and it costs $200,000 to build the cell.

Mr. DARMAN. Right.

Mr. RANGEL. To create the jail, because right now the private sector is fighting that they do not have a labor market, they do not have communities that they can bring their people in and raise a family, and they are willing to take a hit on tax credits even though, you know, this committee is here to save money not to provide incentives.

But if it is going to be a partnership with the private sector, it helps if your office could prepare some data which would clearly indicate if we do not do something now, one way or the other, they have got to pay in taxes, whether it is local or State.

Mr. DARMAN. The hard part is figuring out what is the programmatic solution to prevent yourself from having to incur that cost.

Mr. RANGEL. That is not hard, Mr. Darman, because all you have to do is to go to the communities that have the high numbers of people that are homeless, go to the communities where you have these welfare hotels, go to the communities where you have substandard housing—you will see that these kids are really not prepared to get an education in school, they have overly aggressive behavior patterns. The unions, the teachers' unions, give them the option after a couple of years' seniority to go to communities to teach where they find it more pleasant to teach.

When you find the kids not having a support system, it is not that the Government can support parents, but we need recreation, we need counselors, we need some stability in these communities.

Now, you cannot get it in dollars and cents in your budget, but you have to believe that providing decent housing, which no longer is considered to be a Federal obligation—our budget from 1980 has decreased from $35 to $7 billion—is something that provides a payback. We always thought that these were local and State problems and that they should deal with it, whether it is education or housing.

But if you know that, as a result of us not doing it, they are not doing it, we ultimately are going to get stuck with the increase in expenditures. I do not think you have to be a sociologist to see the connection between the problems that we are not taking care of and the problems that we will have to take care of in the future.

Mr. DARMAN. Well, some of the ones, of course, we already do agree on. For example, we are increasing Head Start, not yet serving the full population that is eligible, but providing a $250 million increase; the child care initiative, I think, is sensible from the standpoint you are talking about. Just helping with income, but ultimately it will help those children at least in some number grow up to be more successful citizens. It takes a little of the stress off the families in question.

Medicaid, some of what is being done there, that we are proposing, as opposed to the prior proposals, will be helpful. The drug thing, I grant you, it is a billion-dollar increase, 1990 over 1989. It is not as much as was contemplated at the time that the bill was authorized, though it is more than was appropriated in 1989.

Mr. RANGEL. You are getting back to dollars and cents, but I think——

Mr. DARMAN. I am trying to say that we made some of these decisions agreeing with you.

Mr. RANGEL. No, what I am saying is, you promised me, and I accept it, that you are going to do some studies in this, because pushing one button, and cutting another program, you are doing the best you can. I applauded everything that the President put in for a kind and more gentle America.

But, unless we have an overall comprehensive program and a partnership between the cities, States, and the private sector, it really doesn't make any difference to give to one program because it sounds good, while you are cutting another program. This is especially so in providing home and shelter for the poor.

Mr. DARMAN. The single, most important thing I believe we have got to do, stating my own personal prejudice on this is to get more jobs to these areas.

I agree with the need for the rest, but you do not have——

Mr. RANGEL. You cannot give jobs to a dropout. They are not prepared——

Mr. DARMAN. No, but you were referring before to the problem of the infrastructure—the community itself being in a state of decomposition in a lot of ways. Families, and a lot of the traditional community support systems just are not there as well.

My own personal view, is all I am saying, is that you have to pick the single most important variable to start to have as the core thing to work around, to help rebuild that whole infrastructure. You have got to get employment into those areas.

Mr. RANGEL. You try getting employment for a reformed addict, or a high school dropout.

Mr. DARMAN. You will not get it for those people, but for the next generation, they will be a lot better off if they have grown up in a community where there have been jobs available.

Mr. RANGEL. Let me work with you on your bias, then. I do not care where you start.

Mr. DARMAN. OK.

Chairman **Rostenkowski**. Mr. Pease.

Mr. **Pease**. Thank you very much, Mr. Chairman.

Welcome, Mr. Darman. It is good to have a person of your abilities in the position that you serve in.

I am reading your testimony on page 9, and at the top of page 9, you say, "We mean to be cooperative," and then you say, a few sentences later, "We must come to an executive/legislative agreement. We must negotiate. The only question is whether to do so promptly or late."

Negotiation usually involves a two-way street, in terms of working on deficits. One way to attack them is cutting spending; another way is raising revenue.

But my understanding is that the administration, although it wants to be cooperative and wants to negotiate, has ruled out one-half of the possible equation.

Is that correct? Is that any way to be cooperative?

Mr. **Darman**. Well, I have tried to say something a little bit different, Mr. Pease, on that point. It is obviously the case that the President has spoken very clearly as to his views on the revenue issue, with the no new taxes statement, and so on.

But, when asked, are revenues ruled off the table for purposes of negotiation? I have taken the position that you cannot go into a good faith negotiation and say that your position is not only right but that you will not consider any other position.

So, what I have said is that we will look at anything on its merits. Our entering position is that the merits do not require a tax increase. But we have not said—neither I nor Secretary Brady, nor the President has ever said—that we would stomp out of the room or refuse to enter the room, or that we want to enter into a long discussion about the shape of the table, in effect, and what the preconditions are and all that.

We have tried to say, look, let's skip all of that, and when we get to discuss things we will discuss them on the merits.

Mr. **Pease**. Well, I think that is very encouraging.

Would you say that entering into negotiations the administration does not have the position that it will not accept at the end of the negotiation any agreement that involves new revenue?

Mr. **Darman**. That is our position. We do not believe that—other than the revenue measures which we propose—other revenues are appropriate to the solution.

But it is also consistent with my prior comment. You cannot say — you would be saying the same thing with different words if you said—nothing is ruled off the table, but, by the way, there is a whole category of outcome that is totally unacceptable.

I do not want to be misleading on the point, though. The President feels extremely strongly on this. If someone were going to change his view on the merits, it would be quite an enormous undertaking.

But, again, in the spirit that you pointed to first—of trying to be constructive, cooperative and acting in good faith—you cannot say that we are absolutely, totally, completely, never, ever, ever, et cetera.

Mr. **Pease**. OK, well, I do think that is very reassuring.

Let me turn now to the line of questioning originally raised by Mr. Gradison on the State and local employees being subject to the Medicare payroll taxes.

You know, I am from Ohio as well, and I was intrigued by your definition of what is a new tax and what is not, and I gather that the current operative definition is whether the proposal was originally made by either Reagan or Bush during any time during the Reagan administration and not specifically rejected during the campaign?

Is that correct?

Mr. DARMAN. Or at any other time, yes, by President Bush, not rejected by President Bush.

For example, there were, I think, in 1982, some contingency tax proposals for an oil import fee and an income surtax, but President Bush subsequently renounced those, so those would not be grandfathered under the definition of the duck.

Mr. PEASE. Sure.

Mr. Darman, when was that definition established?

Mr. DARMAN. It was established as a condition for getting myself confirmed, before the Senate Governmental Affairs Committee.

Mr. PEASE. So, it was just——

Mr. DARMAN. Five hours to pin me down.

Mr. PEASE. That definition could not have been known then to Ohio voters during October of 1988?

Mr. DARMAN. I think that is a fair point, although I think that on this particular issue it does have a certain common sense reasonableness to it. I mean they would not have been misled if they had fought this.

Mr. PEASE. Sure.

All right, let me ask you another question before my time expires.

In response to a series of questions from Mr. Schulze, you took a fairly hard line, whether it measures with the tax increases or not; but then when you got on to the question of the State and local employee payroll tax, you said, well, sure it would be an increase for residents of Ohio and public employees in Massachusetts, but fairness comes into the picture. Why expect people in other States to subsidize Ohio and Massachusetts public employees?

Are you suggesting that if we use fairness as a criteria that we might be able to get around this tax issue? You seem to suggest that.

Mr. DARMAN. No, I was just saying that this one had already been grandfathered for the reasons that we just discussed; but also, I was arguing that it did have some merit when I pointed to the fairness issue.

That obviously has always got to be a criterion in assessing tax policy merits. But I was not trying to suggest that we could come up with a whole new approach to the Tax Code that we judge to be much more fair.

I think we did that together and pretty well in 1986.

Mr. PEASE. Yes, you supported fairness a great deal in 1986, and I thought maybe you still had some lingering devotion to fairness.

Mr. DARMAN. I still like it. I am not sure I want to reopen tax reform in the large sense.

Mr. **Pease**. Thank you, Mr. Darman.

Chairman **Rostenkowski**. Mr. Donnelly will inquire.

Mr. **Donnelly**. Dick, we appreciate your patience and your candor. This can be a tortuous process both for us and you, and I think after I question, it is over for you.

I do not want to beat to death this issue of covering State and local employees under Medicare. It has been an issue that has been debated in this committee ad nauseam; and, if past indication of the committee's action is indicative of the future, I think you have a dead duck on your hands. At least, the little guy is pretty badly wounded.

But I would like for the individual on your staff that came up with the revenue estimate of $2 billion, to forward to the committee the basis on which they made that revenue estimate.

A few years back, we mandated that all new public employees be included in the system, and since then your revenue estimate has jumped from $1.6 to $2 billion. It is hard for me to imagine that those numbers could be correct.

Also, that statistic you used about no public employees in either Massachusetts or Ohio belonging to the Medicare system, I am afraid, is incorrect, because that would be the assumption that no new public employees were hired in either of those States over the last 3 years.

So, if possible, if whoever made the estimate could forward to our committee staff the basis on the estimate, we might be able to debate this wounded duck a little better.

[The following was subsequently received:]

The Office of Research and Statistics at the Social Security Administration—not OMB—estimates the receipt effect of the administration's proposal to extend HI coverage to all State and local employees. The reason the estimate of the first year effect of the proposal has increased from $1.6 to $2 billion is as follows:

The $1.6 billion estimate was based on an effective date of January 1.

The $2 billion estimate is based on an effective date of October 1, providing 3 additional months of receipts.

The zero participation figures I cited in my earlier response were for calendar year 1984. You are correct in stating that current participation would be greater than zero because of the requirement that all State and local employees hired after March 31, 1986 be covered under HI.

Mr. **Donnelly**. I tend to agree with what you say in your statement about your proposed Medicare cuts. I agree that either the cuts that you recommend, or the cuts that we agreed to in the past, were not actually dollar reductions from past years but actually reductions in the rate of growth of Medicare.

One of the problems I do have, though, with your recommendations is that they seem to be driven for fiscal reasons, and not for reasons of public policy.

So, if I could, I would like to ask you one or two questions of public policy regarding Medicare.

Do you think it is fair for the Medicare program to subsidize the training of physicians, as we do under the present system?

Mr. **Darman**. Well, no. And our proposal would cut back on the degree of that subsidy.

Mr. **Donnelly**. It would, but it would not eliminate it?

Mr. **Darman**. No, it would not eliminate it. But it is not clear to me why that should be construed—what one has to do is to calculate what portion of that payment is actually accruing to the Medicare beneficiaries, and I am hard-pressed to figure out why the large amount that would be the subsidy is accruing to the Medicare beneficiaries.

Mr. DONNELLY. But the problem I have, I know of no other health care insurance system that provides this type of direct benefit, other than Medicare, not only for the training of physicians who end up becoming some of the highest paid professionals in America, but also for the reconstruction and building additions to hospitals.

If we need to contain Medicare expenditures, which I think we need to do, we really need to get to some agreement on basic public policy decisions. It might have made sense in the sixties, and maybe early seventies, but does it make sense today, in 1989, that we continue to the tune of billions of dollars to subsidize the training of physicians or to pay for the construction or reconstruction of hospitals?

Mr. DARMAN. Well, I think the answer is probably no, but the reason that you cannot handle this on a purely, what you would call a public policy basis, in my opinion, is that the——

Mr. DONNELLY. Because of the politics?

Mr. DARMAN. It is partly the politics, but it is partly that the system is a kind of in-between system. It is not a fully regulated and socialized system, and it pretends to be somewhat of a private system. But it really does not have the characteristics of private competition, and it has all these peculiar characteristics that go, and very understandably so, with socialized health care, where it is not only insured, but where the individual tends almost always—even with the cost-sharing system—to conclude that that individual always needs a little bit extra margin of safety.

So, you do not have any of the natural protective mechanisms that come from market mechanisms, and yet we do not have a wholly regulated system, and we do not want one.

Mr. DONNELLY. I agree. If I could stop you there. I have waited 3 hours for 5 grungy minutes——

Mr. DARMAN. Could I ask the Chairman if he would give you mine?

Chairman ROSTENKOWSKI. Well, I will let Mr. Donnelly go for as long as he wants to, as long as it is 2 more minutes.

Mr. DARMAN. Could I just take 2 more minutes and it not count against your time? With the chairman's permission?

What I was going to say is that if you have got this kind of hybrid system, it is going to be prone to enormous cost escalation, and it threatens not only to take ultimately from defense—if we go to sequester—but to take from domestic discretionary programs and other things if we do not bring it under control.

And yet, as a society, we are not really prepared to go one way or the other; we are not really prepared to make this into an effective competitive system, and we do not quite want to leap in the other direction and make it a wholly socialized system.

So, we have got this hybrid system moving out of control, and for fiscal reasons, we are always driven back to sort of just restrain it.

Mr. DONNELLY. What we are doing is nibbling around the edges.

Mr. DARMAN. Right.

Mr. DONNELLY. And having probably an extremely inefficient and not cost-effective system.

Medicare beneficiaries today pay a greater percentage of their income in health care costs than they did before 1965. It is bizarre.

Just one last question: Do you see in the outyears any potential for expansion of Medicare, most especially into long-term care coverage for the elderly?

Mr. DARMAN. Well, I would not——

Mr. DONNELLY. Is there room in the budget?

Mr. DARMAN. Not now in terms of the way in which it is financed. In fact, until we have an estimate of what the drug coverage cost is under the new catastrophic bill, we will not know whether the existing system is itself satisfactorily financed.

Mr. DONNELLY. So there will be no recommendation from the administration that we expand into long-term care coverage?

Mr. DARMAN. There is certainly not any right now. I cannot say that we will never reach a point where we will not make such a recommendation. If this administration gets into a second term—as I know, of course, we all hope it will—then we are certainly going to have to face up to the fact that our long-term care system is not adequately financed.

But we cannot address that issue in this fiscal context.

Mr. DONNELLY. And in this Presidential term?

Mr. DARMAN. I cannot speak for great long time periods like this Presidential term, but I feel strongly that——

Mr. DONNELLY. This Congressional term?

Mr. DARMAN. This Congressional term I could feel confident about.

Mr. DONNELLY. Thank you, Mr. Darman.

Mr. DARMAN. Thank you.

Chairman ROSTENKOWSKI. Any further questions?

[No response.]

Chairman ROSTENKOWSKI. Well, Mr. Darman, I heard on the campaign trail, with great acceptance, that the administration was looking for a kinder and gentler America. I think this administration has a kinder and gentler atmosphere in which we are all working.

I agree, certainly, that we ought to put our shoulders to the wheel, and we ought to get our economic house in order. I have had the pleasure of sitting with you on a more personal basis, and with the administration, including the President.

I do think that ultimately we are going to pass legislation here that is going to serve our country well. I do not know how we are going to get there. I wish I were a producer and director of the avenues of approach toward doing what is responsible, but I still note the atmosphere of politics, and I think that that is sad.

I have said this before in this committee that people expect us to govern, and you are well aware of my opinion with respect to the two outstanding applause-generators in the President's speech: one, we ought to quit the bickering; and, two, we ought to do something about drugs.

I think quitting the bickering means getting your house in order and doing what is legislatively necessary, and doing administratively what is necessary.

We will sit here and talk about whether revenues will be included in the package or whether they will not be included in the package, how much we can cut in the domestic programs or what we are going to do in defense; but I think ultimately we are going to see a summit. I think that you will be a part of the negotiating team, and if I keep my nose clean around here, maybe I will be a part of the negotiating team.

But I think that at that point in time, if we do come back with a bold reappraisal of what we as legislators ought to be doing, that we will have the courage to campaign for it on both the minority and the majority sides with the assistance of the administration, and that ultimately the members of this committee, as well as the Members of the House and Senate will have the courage to pass it, because I think what we are all trying to do is work in the best interests of our country.

I want to thank you again for this long dissertation, and I think, too, that you have helped us in great measure, trying to fashion what I think is going to be a necessary piece of legislation.

Mr. DARMAN. Mr. Chairman, could I just add a word before you close?

First of all, thank you very much, I have enjoyed being here today.

If I could comment on your last comments. One thing we in the administration know for a certainty is that this cannot be done without you and the Ways and Means Committee.

As I suggested in the testimony, but I did not read fully, the very, very large portion of what we are in need of addressing is in the jurisdiction of this committee. Obviously we recognize that a summit will not be a summit unless the chairman of the Ways and Means Committee is a participant, so we would look forward to working with you in the expectation that it is not only enjoyable but essential.

The second general point, just in closing, is that we may differ—and we do differ on a lot of these substantive issues that have come up here—but I think we share something that is extremely important, and that is faith in this system's ability to work in the end.

We go through these sort of odd paths, very rarely straight lines, and you know this much better than I. But I remember early in the morning — I think it was around 1 o'clock in the morning — when you and your colleagues went off in there, and a number of us were sitting here, and people were saying, "Tax reform is dead" for the 20th time. And in the weeks that followed, an awful lot of people—for a short time even the administration—were acting as if tax reform was dead. And tax reform is alive, well, with us, and the system managed to do the impossible and come together.

I do not think that this job before us is quite as hard as that was. And so I am confident that even though there is quite a number of little differences that have shown up here today, that somehow or another we are going to be able to come together on these things because that is what the system does; and, in the end, I agree with you, we are going to come together, and we have got to. The deficit has to be reduced, and we will find a way collectively to do it, I believe.

That may be an impression of naive faith, but it is one I think we share.

Thank you very much.

Chairman Rostenkowski. Well, thank you, Mr. Darman.

The committee will stand in recess until 2 o'clock.

[Whereupon, at 1:05 p.m., the committee recessed, to reconvene at 2 p.m.]

Chairman Rostenkowski. The committee will come to order.

This afternoon, we will continue to hear testimony from the administration officials on the budget. We take these recommendations with hopes that the administration and Congress can work together to produce a reasonable budget that will reduce the deficit.

Today, we welcome for the first time Dr. Louis Sullivan, Secretary of the Department of Health and Human Services, to the committee.

As you know, Dr. Sullivan, much of what goes on in the Committee on Ways and Means relates directly to the activities in your Department.

Many of the programs within both of our jurisdictions are going to be under considerable scrutiny. We are particularly interested in discussing the President's proposed Medicare cuts. The Medicare program was originally enacted in 1965, and is considered one of the most significant additions to the health policy in this country.

Unfortunately, it has also become the faster growing major program in the Federal budget. And legislators are frustrated as to how to contain its costs.

The Medicare budget will be cut, but we need to discuss just how much of a cut can be tolerated.

As I indicated to Mr. Darman this morning, cuts of $5 billion in Medicare for fiscal year 1990 and $53 billion over the next 5 years are much too steep. They are not feasible, and do not, in my opinion, have the Congressional support on either side of the aisle.

We are also interested in monitoring the implementation of the Welfare Reform Act, which came out of this committee last year. We certainly are disturbed that the administration has submitted language which suggests that the JOBS Program is not to be fully funded on an entitlement basis.

This undercuts the purpose of the Act and disrupts State planning for the implementation of these important reforms.

I notice, Doctor, whether or not you did that intentionally, but you worked the room, and shook hands with all of my colleagues, and I am sure that that is the first step in the right direction of getting a program passed. I want you to know that we welcome you to the committee, and we certainly welcome you to the world of health policy and to the reality of budget deficits.

So, we look forward, Doctor Sullivan, to hearing your testimony, and I am sure that you will find us as agreeable as the budget permits.

Mr. Archer will respond.

Mr. Archer. Good afternoon and welcome, Dr. Sullivan. We are pleased to have you come before our committee today.

As you know, we have the jurisdiction over several of the most important programs administered by your department. We are looking forward to a long, friendly, and productive relationship with you in the years to come.

I am completely confident that your appearance this afternoon is going to lay the foundation for that relationship between our committee and HHS in the years ahead.

With your permission, for the benefit of my colleagues, I would like to publicly recognize the qualifications and achievements that you bring to your new job. Along with everyone else, I am impressed that you were able to start a first-rate medical school at a university that was not financially well-endowed.

Having observed the political problems experienced by universities and colleges in our own States, we can appreciate the foresight, tenacity, and political skill that went into that achievement.

We would like particularly to cite the commitment you have shown throughout your career to the less fortunate citizens in our Nation. I note especially the emphasis you placed on community service by your faculty and students at Morehouse.

If more institutions would evaluate that model, I dare say the health of our less advantaged citizens and their children would be improved, and the need for constantly growing government medical programs would be reduced.

So, it is a privilege for all of us to have you appear before us today, and we look forward to working with you.

Chairman Rostenkowski. Dr. Sullivan, the committee is ready to receive your testimony. I might add, too, Dr. Sullivan, that your entire statement, if you care to summarize, will be included in the record, and you may do what you wish to do.

STATEMENT OF HON. LOUIS W. SULLIVAN, M.D., SECRETARY OF HEALTH AND HUMAN SERVICES

Secretary Sullivan. Thank you very much, Mr. Chairman.

Thank you and Mr. Archer for your very kind remarks, and I am very grateful to you for this opportunity to appear before you and your colleagues on the Ways and Means Committee.

As you have indicated, this is my first opportunity since I was confirmed by the Senate some 6 days ago, to appear before a congressional committee, and I am very grateful for that opportunity.

Today, I am privileged to have the opportunity to discuss with this committee the broad contours of the hopes and aspirations which President Bush and I share for the Nation's citizens.

These hopes center on the President's commitment, which I fully share, the ideal of a "kinder, gentler" Nation. The Department of Health and Human Services is at the center of that commitment of the President, which I share.

Taking that commitment as my guide, I will assure that the policies that we promulgate at the Department carry a firm but gentle touch, and that we reinvigorate the commitment of the employees of the Department to carrying out the services for which we have been charged.

During my career, I have seen remarkable progress in the Nation's system of health care, with programs like Medicare and Medicaid making health care more available to our less fortunate citizens.

I have seen improvement in the lives of our children and less privileged through the Department's programs. However, in spite of this progress, much remains to be done; but it must be done while reducing the Federal budget deficit, a concern I know you share with me.

Let me highlight how we might begin to make further progress towards improving the health and well-being of our citizens, bearing these constraints in mind.

First, we are committed to the ongoing solvency of programs like Social Security and Medicare and their trust funds. We must find ways to contain escalating medical costs without sacrificing our commitment to quality health care for all. We must emphasize health promotion and preventive medicine strategies because promoting health is ultimately more cost-effective and more humane than simply treating illness.

In only 6 short years since the bipartisan commission put the trust funds back on the road to solvency, we can report that in 1990 trust fund income will exceed outgo by nearly $69 billion.

The combined reserves of the old age and survivors trust fund and the disability trust fund will be approximately $229 billion by the end of 1990.

By 1992, the trust funds will have a full year of benefits in reserve. The reserves are necessary, and will be used, to fund the benefits of the baby boom generation as they begin retiring in the next century.

President Bush proposes to increase Medicare spending by about 10 percent in 1990 compared with 1989, that is, a total increment of $8 billion, while at the same time seeking ways to restrain excessive growth in costs of our health care system.

Second, we must sustain and improve programs like Head Start and aid to families with dependent children, programs that help the poor learn and work their way out of poverty. Implementation of last year's Family Support Act will therefore, be one of my highest and earliest priorities, a priority I share with this committee.

The act's most fundamental change was the creation of a new program of work and training activities, the JOBS Program, which all States must have in effect by October of 1990.

States can elect to replace existing work programs with JOBS as early as July of this year. I intend to ensure a speedy implementation of this act with the issuance of program regulations early this spring. We must do all that we can to encourage welfare recipients to become productive members of this country's workforce.

Welfare reform also made improvements to child support enforcement, and I want to report to the committee that child support collections continued to rise. We project that increases in 1990 will exceed 1989 estimates by 17 percent, or $931 million.

The strong congressional commitment to enforcement activities has helped bring this important parental financial responsibility issue to the forefront in State capitals across the country.

Third, attention to family means that the health of our children must be our particular concern, for nothing less than our Nation's future is at stake. That future is threatened by the scourge of drug abuse among our young and is a concern which I share with the President.

Fourth, we must sustain our biomedical research efforts in the quest for a cure for AIDS. As the President has said, "We must commit the resources and the will to find a cure. American science must know that we have the resolve to beat this disease."

At the same time, however, we must not slight our efforts to conquer cancer, heart disease, diabetes, arthritis, and other disorders afflicting our citizens.

Finally, in an era of limited resources, we must focus those resources on the poor, the disadvantaged, and the neglected in our society. Programs like Medicaid must be carefully administered so that rural and inner city health care needs are met, and the nation's poor are accorded decent care with dignity.

We will soon send to the Congress legislation to enhance Medicaid services for children, including expansion of immunization services.

I would now like to return to the question of Medicare spending.

Within my department, the rising costs of Medicare continue to be the primary force driving excessive budget growth. If no spending restraints were imposed, Medicare benefit outlays would grow at a rate of over 14 percent in 1990 to more than $110 billion.

However, simply extending three provisions, the 85 percent capital payment, the 25 percent part B premium floor, and extending clinical labs limits, would retain the policies currently in effect in 1989.

Allowing these provisions to expire would increase Medicare spending by about $2 billion in 1990. Even with other proposals totaling about $3 billion in outlay reductions, the Medicare program will still grow by 10 percent, or $10 billion in 1990, and growth in Medicare Part B costs will still be more than 12 percent.

The 1990 Medicare budget is based on a policy of reasonable deficit reduction with savings proposals aimed at reducing unnecessary and unwarranted spending, while at the same time improving equity in payment levels for services.

Growth in Medicare expenditures for inpatient hospital services has been moderated under the prospective payment system.

However, there remain subsidies in the hospital system which are clearly excessive, particularly in the area of reimbursement for capital expenditures. These excessive payments must be addressed, and we believe that this is the appropriate time to correct these problems in Medicare part A.

President Bush's budget contains proposals to reduce the growth in part A outlays by almost $2.4 billion in 1990. The budget also proposes a series of steps aimed at slowing the continuing high rate of increase in the Medicare part B program, while also bringing about improved equity in payment levels for services. Part B benefit costs increased at a rate of over 17 percent per year from 1979 to 1987 and increased by 12 percent in 1988.

Unlike part A, where the Government has been able to address most costs through a single overall approach, Medicare part B is a very complex program for which no overall approach has yet been identified for controlling cost increases. The steps proposed in this budget are not expected to be the whole solution to the problem, but are measures clearly called for based upon our current knowledge. Increased attention should lead to more comprehensive and long-range solutions to the basic problem of large and continuing cost increases in part B.

For physicians' services, a graduated approach is taken in the budget to bring about more equitable payment levels. For primary care services, which are underpaid relative to other services, the budget proposes to increase prevailing charges by the full Medicare Economic Index, in each of the next 3 years. For most nonprimary care physicians' services, the budget proposes to freeze prevailing charges for 1 year. For certain specialties and procedures that our Inspector General has identified as overpriced, the budget proposes to reduce payment levels in a graduated fashion, ranging from a 12 percent reduction for a number of selected procedures, to an 8 percent reduction for radiology, anesthesiology and surgery service.

Mr. Chairman, let me make two things clear:

First, we are not adamantly insisting that the proposals that we suggest here are the only way to restrain Medicare growth. We believe that they represent a fair and equitable approach, but the administration is willing to discuss other approaches that the Congress or others may suggest. But, second, we must restrain Medicare growth in some manner. We cannot allow Medicare to continue to grow at a 14 percent growth rate annually.

A 14 percent annual growth rate would result in Medicare outlays in 1995, only 5 years away, of over $200 billion. This level of growth, I am sure you will agree, will make any new initiatives very difficult, if not impossible, to achieve.

Thank you very much, Mr. Chairman, for this opportunity to present my statement.

[The statement of Hon. Louis W. Sullivan follows:]

STATEMENT OF LOUIS W. SULLIVAN, M.D.
WAYS AND MEANS COMMITTEE
MARCH 7, 1989

Mr. Chairman, Members of the Committee, I am pleased to appear before you today to present my first congressional testimony since my confirmation by the Senate six days ago. I am pleased to enjoy the trust of our new President, and as Secretary of Health and Human Services, I shall carry out the task he has given me in such a way that the hopes and aspirations we mutually hold for this Department, and for the American people, are fulfilled.

Today, I am privileged to have the opportunity to discuss with this distinguished Committee the broad contours of those hopes and aspirations. They center on the President's commitment -- a commitment I fully share -- to the ideal of a "kinder, gentler" America. No Department will be more directly affected by that commitment than HHS, which touches the lives of Americans wherever they are most vulnerable -- from the beginning of life, through health and sickness, from the foods we eat to the medicines we take, to the care of the elderly and disabled.

Taking that commitment as my guide, I intend to see to it that our policies at HHS carry a firm, but gentle touch; that HHS employees take pride in the invaluable service they render our citizens; that government itself comes to have a more human face. Bringing a new spirit of kindness and compassion to a vast federal Department may seem excessively idealistic. But it is an ideal we can and must attain. Nothing less shall be my goal as Secretary of HHS.

During my medical career, I have seen remarkable progress in the nation's system of health care, with programs like Medicare and Medicaid making health care more available to the elderly and poor. And I have seen the improvements in the lives of millions of our children and less privileged through HHS' programs of human services.

Much remains to be done. But it must be done with an eye to reducing the Federal budget deficit -- a concern, I know, of paramount importance to this Committee, as you consider not only how funds are spent, but how they are raised as well.

Let me indicate how we might begin to make further progress toward improving the health and well-being of our citizens, bearing these constraints in mind.

First, we must assure the solvency of programs like Social Security and Medicare trust funds. We must find ways to contain escalating medical costs, without sacrificing our commitment to quality health care for all. And we must emphasize health promotion and preventive medicine strategies, because promoting health is ultimately more humane and economical than merely treating illness.

In only six short years since the Bipartisan Commission put the trust funds back on the road to solvency, we can report that in 1990, trust fund income will exceed outgo by nearly $69 billion. The combined reserves of the Old Age and Survivors Trust Fund and the Disability Trust Fund will be approximately $229 billion by the end of 1990. By 1992, the trust funds will have a full year of benefits in reserve. The reserves are necessary, and will be used, to fund the benefits of the "Baby Boom" generation as they begin retiring in the next century.

President Bush proposes to increase Medicare spending by about 10 percent in 1990 compared with 1989, while at the same time seeking ways to restrain excessive growth. I will return to some of these measures in a moment.

Second, we must sustain and improve programs like Head Start and Aid to Families with Dependent Children -- programs that help the poor learn and work their way out of poverty. Implementation of last year's Family Support Act will therefore be one of my highest and earliest priorities.

The Act's most fundamental change was the creation of a new program of work and training activities, the Job Opportunities and Basic Skills (JOBS) training program, which all states must have in effect by October, 1990. States can elect to replace existing work programs with JOBS as early as July of this year. I intend to insure a speedy implementation of this Act, with the issuance of program regulations early this Spring. We must do all that we can to encourage welfare recipients to become productive members of this country's workforce.

Welfare reform also made improvements to child support enforcement, and I also want to report to the Committee that child support collections continue to rise. We project that increases in 1990 will exceed 1989 estimates by 17 percent, or $931 million. The strong Congressional commitment to enforcement activities has helped bring this important parental financial responsibility issue to the forefront in State capitols across the country.

Third, we must seek ways to strengthen family life and reinforce our society's sense of community, our shared sense of responsibility and commitment to one another. As President Bush notes, "family . . . is a powerful word, full of emotional resonance," and those of us who have been blessed with strong families must work to bring that blessing to those who have not.

Attention to family means that the health of our children must be our particular concern, for nothing less than our nation's future is at stake. Today, that future is threatened by the epidemic of drug abuse among our young. I am deeply committed to the battle against "this scourge," as President Bush has called it, and will work long and hard with this Committee, with the President, and with his Drug Advisor in pursuit of victory.

Fourth, we must sustain our biomedical research efforts in the quest for a cure for AIDS. As the President has said, "We must commit the resources and the will to find a cure. American science must know that we have the resolve to beat this disease." At the same time, however, we must not slight our efforts to conquer cancer, heart disease, diabetes, arthritis, and other disorders afflicting our citizens.

Finally, we must focus our limited resources on the poor, the disadvantaged, and the neglected in our society. Programs like Medicaid must be carefully administered so that rural and inner city health care needs are met, and the nation's poor are accorded decent care with dignity. We will soon send to the Congress legislation to enhance Medicaid services for children, including expansion of immunization services.

I would now like to return for a moment to the question of Medicare spending. Within HHS, the rising costs of Medicare continue to be the primary force driving excessive budget growth. If no spending restraints were imposed, Medicare benefit outlays would grow at a rate of over 14 percent in 1990, to approximately $110.5 billion. However, simply extending three provisions -- the 85 percent capital payment, the 25 percent Part B premium floor, and extending clinical labs limits -- would retain the policies currently in effect in 1989. Allowing these provisions to expire would increase Medicare spending by about $2.0 billion in 1990. Even with other proposals totaling about $3.0 billion in outlay reductions, the Medicare program will still grow by 10 percent, or $10 billion in 1990, and growth in Medicare Part B costs will still be more than 12 percent.

The 1990 Medicare budget is based on a policy of responsible deficit reduction with savings proposals aimed at reducing unnecessary and unwarranted spending, while at the same time improving equity in payment levels for services. Growth in Medicare expenditures for inpatient hospital services has moderated under the Prospective Payment System (PPS). However, there remain subsidies in the hospital system which are clearly excessive, particularly in the area of reimbursement for capital expenditures. These excessive payments must be addressed, and we believe that this is the appropriate time to correct these problems in Medicare Part A. President Bush's budget contains proposals to reduce the growth in Part A outlays by almost $2.4 billion in 1990.

The budget also proposes a series of steps aimed at slowing the continuing high rate of increase in the Medicare Part B program while also bringing about improved equity in payment levels for services. Part B benefit costs increased at a rate of 17 percent per year from 1979 to 1987 and 12 percent in 1988. Unlike Part A, where the government has been able to address most costs through a single overall approach (the Prospective Payment System), Medicare Part B is a very complex program for which no overall approach has yet been identified for controlling cost increases. The steps proposed in this budget are not expected to be the whole solution to the problem, but are measures clearly called for based on our current knowledge. Increased attention should lead to more comprehensive and long-range solutions to the basic problem of large and continuing cost increases in Part B.

For physicians' services, a graduated approach is taken in the budget to bring about more equitable payment levels. For primary care services, which are underpaid relative to other services, the budget proposes to increase prevailing charges by the full Medicare Economic Index (MEI) in each of the next three years. For most non-primary care physicians' services, the budget proposes to freeze prevailing charges for one year. For certain specialties and procedures that our Inspector General has identified as overpriced, the budget proposes to reduce payment levels in a graduated fashion, ranging from a 12 percent reduction for a number of selected procedures, to an 8 percent reduction for radiology, anesthesiology and surgery service.

Mr. Chairman, let me make two things clear: First, we are not adamantly insisting that the proposals we suggest here are the only way to restrain Medicare growth. We believe that they represent a fair and equitable approach, but the Administration is willing to discuss other approaches that the Congress or others may suggest. But second, we must restrain Medicare growth in some manner. We cannot allow Medicare to continue to grow at a 14 percent annual growth rate. Mr. Chairman, a 14 percent annual growth rate would result in Medicare outlays in 1995, only five years away, of over $200 billion. This level of growth in Medicare will make any new initiatives very difficult, if not impossible, to achieve.

Chairman ROSTENKOWSKI. Thank you, Doctor Sullivan.

Doctor Sullivan, Medicare would only be reduced by $2.1 billion under the Gramm-Rudman sequester. Should not those concerned about hospitals and Medicare prefer to see sequester?

Under the President's budget, it is suggested that we cut Medicare by $5 billion. Certainly, a $3 billion hit would be something that I'm sure many of us on the committee would find palatable. And I am talking about just this committee, not the overall programs, all the social programs that are going to feel the effect.

But how do you reconcile this?

Secretary SULLIVAN. Well, Mr. Chairman, the problem that we would have with the sequester is that it takes away the discretion that we feel we need in administering the funds available to us.

In our hospital system, we have excess capacity. For the latest year, we have data that the occupancy rate in our urban hospitals has been around 60 percent, whereas the occupancy rate for the rural hospitals is 40 percent.

We have excess capacity in the system and feel that our approach of trying to reduce that excess capacity so that funds can be targeted in areas where they are needed to a much greater degree is correct.

A sequester would tie our hands in the ability to utilize the available funds in the most effective way.

Chairman ROSTENKOWSKI. Well, Doctor, the most difficult Medicare reductions, as far as I am concerned, is the $1 billion cut in indirect hospital teaching payments.

About 60 percent of these savings would come from the high indigent care disproportionate share hospitals. How can we reduce Medicare to the hospitals that are already hard-pressed by care to the 35 million without hospital insurance?

Are these hospitals not, especially those in Illinois and California, now hit by reductions in the State Medicaid payment?

Doctor, Chicago hospitals alone report that Medicaid only pays 65 percent of the amount Medicare would pay for the same patient.

We have been surgically cutting back over the last 5 years, particularly in the hospital area. I just do not know whether they can afford to get hit any more.

Would you like to comment on that?

Secretary SULLIVAN. Yes, Mr. Chairman.

We are very concerned about programs designed to address the medically indigent and those less fortunate in our society. However, the Department has a program to provide supplements to those hospitals that have a disproportionate percentage of the medically indigent.

We think this is one way to address those hospitals that have a high percentage of those individuals.

We have looked at our teaching hospitals and the medical education subsidy and other adjustments that have been made, those tend to be the most profitable, having the highest operating margins of our hospitals.

We feel that to be equitable to all of the hospitals in our system, we have to be concerned about nonteaching hospitals, rural as well as urban hospitals, and try to address their needs also.

While we would not argue with the fact that all our hospitals are going to have to find ways to operate more efficiently and to limit or get rid of excess capacity, we feel that the teaching hospitals have to share in that effort. They are doing relatively better than the other, nonteaching hospitals.

Chairman Rostenkowski. Mr. Archer.

Mr. Archer. Thank you, Mr. Chairman.

Dr. Sullivan, I know that like you have a great concern for low income people getting adequate medical care. You also have a great concern for the elderly, and I am sure that you are aware that some elderly workers will lose more than $1 to taxes and lost Social Security benefits if they earn an extra $1 in wages.

The Medicare catastrophic illness income surtax, the taxation of half Social Security benefits, and the loss of $1 of Social Security benefits for every $2 of wage income above the threshold, results in many elderly workers being worse off if they earn more money.

Let me give you an example: An elderly widow earning twice the minimum wage will see her net spendable income reduced by $27 if she receives a $1,500 raise.

A married man earning only $8,880 will cause an $18 decrease in his total income if he accepts a new job paying $1,000 more in wages.

Many people have suggested that we repeal the earnings test, which would significantly reduce these kind of results. I wonder if you would be supportive of that.

Secretary Sullivan. Mr. Archer, we are interested in various strategies that will maintain the productivity of our older citizens. We are interested in exploring ways of doing that.

At the same time, we want to be sure that we maintain the solvency of the trust funds in our Social Security system so that any changes that are made do not endanger the commitment that was made back in 1983.

This is an issue that we are reviewing within the Dpartment and within the administration. It is a very difficult and complex issue. I wish I could give a more specific answer at this juncture because we are very much concerned about it.

Mr. Archer. Along that line, would you support a re-formation of the funding mechanism for catastrophic illness to move away from the special marginal income surtax that is applied only to those 65 years old and older?

That is also one of the contributing factors to these sort of case studies that I mentioned to you where the elderly who work lose money if they earn more.

I do not see how our system can tolerate that.

Secretary Sullivan. I think we want to scrutinize that more closely as I move into the Department. The catastrophic care bill was just enacted this past year. We are aware of a number of concerns that have been expressed. But looking from the other side, we are also concerned about the many examples of our elderly citizens being wiped out financially by the tremendous costs of illness. With our aging population, we are going to be seeing more of that.

Because this legislation has just been enacted, and we really do not have much experience, we would like to see if adjustments need to be made further. We do feel that the catastrophic bill fills a need for our older citizens and are concerned about trying to protect them. Therefore, we would be reluctant to engage in tinkering before we have had more experience with the new law.

Mr. ARCHER. My question did not relate to the benefit structure, but to the method of funding, and I am sure that you are aware that this catastrophic program covers not just the elderly, it covers everyone who is subject to disability under the provisions of the Social Security Act.

Donald Trump, with all the money that he has, could be disabled tomorrow in an automobile accident, and would be eligible for catastrophic coverage.

And, yet, those 65 years old and older would pay all of the costs. I wish the administration would support changing it because it is extremely unfair for those who can no longer protect themselves, who are dependent upon their retirement income, and who face the potential of a marginal tax rate that can be as much as 38 percent.

At a time when we passed the tax bill in 1986, it guaranteed everybody that 28 percent would be their top rate.

I would like to ask you one other question relative to Medicare coverage. In Houston, Texas, we only have one downtown hospital left. All the rest have been unable to continue, unable to survive economically, and Houston is a very big city, the fourth largest in the country.

That hospital is St. Joseph's Hospital, run as totally a charitable nonprofit operation. They tell me that, if they do not get some increase in the Medicare reimbursements that are currently made for the various classes of treatment and illnesses, that within 5 years, they are going to have to close their doors.

Is the administration proposal taking into account these hospitals that have large percentages of elderly covered under medical care who are not getting adequately reimbursed to cover their costs?

Secretary SULLIVAN. Mr. Archer, what I want to do is to look at the specifics of hospitals such as St. Joseph's, before I answer. One of the problems in the hospital system is that each one of these institutions a unique situation of its own.

Mr. ARCHER. That is true.

Secretary SULLIVAN. On the other hand, we are committed to doing everything we can to guarantee access to health care for the citizens who need it. We are concerned if an institution that is vital to a community is endangered. It is very difficult to give a blanket response without knowing more specifics.

Mr. ARCHER. Sure.

Secretary SULLIVAN. But I can assure you that my colleagues in the Department will be pleased to look into this situation.

Mr. ARCHER. Thank you very much, Doctor.

Chairman ROSTENKOWSKI. Mr. Stark will inquire.

Mr. STARK. Thank you, Mr. Chairman, and welcome, Dr. Sullivan. Congratulations on your new post, and I am sure I speak for the entire membership of the Subcommittee on Health when I say that we look forward to working with you in the years ahead.

It may surprise you, even my chairman, when I said, if we were just operating here in a vacuum, your $5 billion cuts in Medicare perhaps do not sound so bad to me. I have always suggested that we should get our rate of inflation for the increase in medical costs down to around 8 percent a year, and they are running at 12 or 13.

So, your numbers, if we had some time to make the system more equitable and play catchup ball, might make some sense. That is as kind and gentle as I care to get because having said that, when I look at what our subcommittee's record is, of cumulatively cutting $20 billion out of the system in the last 4 years, while we watched Defense probably increase $50 or $80 billion, and when I have to look at Defense on the basis of your suggesting a $5 billion cut, Defense is really getting an increase.

And that will not wash. I am not willing to see the deficit go up and see the Government, in effect, steal from our Medicare trust fund when it should be leaving that money in to reduce the deficit.

So, we cannot talk about Medicare just in a vacuum. And you and I may not have a lot to say about that. That may come to us from the Budget Committee. So, let's set aside, if we can, whether it should be $5 billion or a little under $2 billion, as I think. In fairness, my alternative is to say, let's sequester, if I were just looking at Medicare, and I would end up with a $2 billion cut, and Defense would take a bigger hit, and we would not raise taxes, as the President has suggested.

My guess is that we might be closer to $2 billion, but I would like to talk with you a little bit about the structure, because whether it is 5, or 1, or 2, we are going to have to deal with how we contain the costs of medical care in this country with particular reference on this committee to Medicare, but you will have other committees in Congress who will want to deal with Medicaid and perhaps someday long-term care, the uninsured, which I suspect are costing us money in Medicare, although we do not recognize it as a cost.

Our committee has always suggested that a principle is that we should not sacrifice or force indirect increases of costs on the beneficiaries and not sacrifice access for them.

Would you concur in that as kind of a principle from which we ought to begin?

Secretary SULLIVAN. Yes, we are concerned about access to medical care, and we are committed to doing everything we can to maintain that access.

Mr. STARK. And when I suggest that we should not increase the cost to beneficiaries, what I am suggesting is that we have established their premium for part B, and we have established the deductibles and the copays and we have indicated that medical services ought to be available at certain rates, whether it is assignment rates or those who accept, who participate so that without radically increasing those hidden costs to the beneficiaries, we ought to try and protect them from an unforeseen cost.

Would you agree with that?

For example, if I concur with you and say, I think—and I do, I think we have got a lot of high-priced procedures, and while I think we ought perhaps to look at completely revising the reimbursement structure for physicians, even if we control the volume, and the fees, extra billing goes on; and senior citizens are just of a generation where they pay; they do not question the doctor's bill. They pay it even if they have to pay $1 a week for the rest of their lives, they pay it.

And I think that is unfair. They are afraid to question the physician's judgment in payment, and so extra billing just goes right on, everytime we cut.

And I would like to cap that, I would like to see that the beneficiaries just do not get stuck out of pocket through something beyond our control.

In principle, would you concur with me on that kind of a concern?

Secretary SULLIVAN. Yes, Mr. Stark. We are committed to try to ensure that costs are not passed on to the beneficiaries, and I believe that.

Mr. STARK. The other thing I am going to ask you, and this morning, Mr. Darman suggested—I would have called it passing the buck—but he suggested that one of the reasons that we do not have rules on the capital, folding capital into the DRG's, which you alluded to in your testimony, is that it is being held up at Health and Human Services.

One of the reasons that I would like to ask you to come to us as soon as possible with a decision on what your regulations will be is that we have proposed reducing capital reimbursement, direct capital reimbursement of folding it into DRG's for years, and each time we put it off because the clarion call of hospitals that it will go bankrupt keeps touching our sympathy, and I am afraid that if you, if OMB, or you, do not publish proposed regulations about what we are going to do on capital, we are going to be creating a false sense of optimism in the hospitals, and they are going to say, "Ah, they don't mean it. They'll give us another extension."

Whatever you are going to do, it would be helpful to us to know before we begin our cost-cutting deliberations because I agree with you, I think there is excess capacity, both in hospital rooms and high-cost capital equipment, in trauma centers. They are irrationally allocated, and we have to, I think, take the lead on allocating these scarce resources.

New York State is woefully under, has a lack of capital. California has not hit 50 percent full in a long time, and we should be embarrassed as to how much extra capacity we have. Some of that has got to be adjusted to be fair, and I look forward to having you help us adjust for that. One of the things we could do is show the health care providers that you mean business. It will help us, and I think help us accomplish the combined goal.

Thank you very much.

Secretary SULLIVAN. Thank you, Mr. Stark.

Chairman ROSTENKOWSKI. Mr. Gradison will inquire.

Mr. GRADISON. Thank you, Mr. Chairman.

Mr. Secretary, I want you to know how delighted I am with the positive statement that you have made with regard to catastrophic health insurance legislation. We have been catching a lot of opposition to it from constituents, as well as here in Congress.

I want to make sure I understand your position. I recognize that you want to gain more experience, and you have made the point, which is certainly appropriate.

My understanding of what you have said is that you would currently oppose, at this time, repealing or freezing the program?

That you want it to go forward as written until some experience can be developed?

Is that a correct characterization of your statement?

Secretary SULLIVAN. Yes, that is correct.

We feel that this meets a very pressing need, and we would like to proceed with the program.

Mr. GRADISON. Mr. Secretary, one of the provisions of that legislation called into being a new Bipartisan Commission—that is actually what it is called, Bipartisan Commission on Comprehensive Health Care, a 15-member Commission which is just getting started under the able chairmanship of our colleague, Claude Pepper of Florida.

Its charter is to come in with recommendations with regard to long-term care and the health uninsured. I mean, basically, those are the two challenges.

The Commission has tentatively decided to try to complete its work by sometime in November of this year, which is an ambitious but probably attainable target.

I wanted to encourage you to monitor the work of this Commission and very much hope that it will be possible in some way to develop a close working relationship between the department and of the Commission as we move ahead in our work because we clearly would benefit enormously from your input and that of your Department; and, as the same time, we have got an obligation as a Commission to make a timely recommendation to our colleagues in the House and the Senate.

Secretary SULLIVAN. Thank you. We look forward to working with the Bipartisan Commission because we recognize the problem of long-term care. We believe in working with the Commission and having input into its deliberations.

Hopefully, we will help develop some solutions that will be workable and acceptable to all. We don't know what those solutions are, but we think that they will probably involve not only Federal participation but participation by States, local governments, and the private sector in some combination. We look forward to working with the Commission.

Mr. GRADISON. Mr. Secretary, you have achieved success in so many parts of the field of medicine, it is difficult to just pick out one and focus on it, but I do want to pick out one that we have been giving a lot of thought to, and that is the notion of some kind of a relative value scale system of payment for physicians.

When we started with the hospital reimbursement system back in the 1983 legislation, basically the Congress gave the Department and gave the Secretary rather broad authority to put into effect a system of prospective payment.

Later we came along and micromanaged it to one degree or the other, but initially, it was a rather broad authority.

I have been wondering whether it would make sense, and whether it would be appropriate to give to the Secretary authority to put into effect under Medicare the relative value scale system to be phased in over 4 or 5 years on a revenue-neutral basis with a minimum of strings attached, and give the department a chance to work this out, using its expertise, and using your special knowledge in this field.

I am not asking you now, I think it would be inappropriate 6 days into office, to ask for a total evaluation of this, but we really do need your input, and since, if we have health legislation this year, it is likely to be a part of a budget reconciliation biil or nothing at all. Really, I would hope that at an early date that you would be in a position to give us your thoughts on the concept of a relative value scale approach, and, in particular on what kind of legislation, if we wanted to do it, you would be comfortable in attempting to implement over a period of years?

Secretary SULLIVAN. Thank you, Mr. Gradison.

As you have indicated, I am new in this position, and I think the Hsiao study and other efforts to look at a relative value scale are under review in our Department now.

However, I do believe that this is moving in the right direction. There is no question that in some areas and with some procedures, we do have excess costs; and in other areas, particularly in the primary care areas, we are underpaying our health professionals because we find that we do not have enough individuals going into those fields. We have areas, both inner city and rural areas, where we do not have adequate numbers of primary care professionals.

Therefore, looking at the relative value scale is indeed a healthy direction, and we intend, to review this closely to see if we can develop some recommendations.

I would welcome the opportunity as Secretary of HHS to have the flexibility to promulgate some recommendations that would resolve this problem.

Mr. GRADISON. Thank you, Mr. Secretary.

Thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. Ford will inquire.

Mr. FORD. Thank you, Mr. Chairman, and again, thank you, Mr. Secretary, for coming before the committee.

Mr. Secretary, I am looking at this flexible freeze. In your testimony before the committee you have talked about the disadvantaged and you have talked about some of the welfare programs. Now, you talk about programs which have legitimate claims and have proven effective and that should be increased to the extent of the additional resources would provide significant public benefits.

Now, when I look at this flexible freeze, I look at the program increases that you're talking about such as WIC, the infant mortality, Job Corps, welfare services, and some in the environmental areas. You also talk about program reductions.

Say, if you have that congressional authority, can you say as the new Secretary, that you already have made a commitment in these areas of possible increases, on how this flexible freeze will it be used? How will you make a determination as to when some of the programs, whether it is WIC, welfare services, trigger in? And how will you determine which of the programs should be reduced?

Secretary SULLIVAN. Mr. Ford, you have raised a very good and very difficult question. We in the administration are committed, as President Bush has indicated, to emphasize programs for children, pregnant mothers, and the disadvantaged. We will use that as our guide, and those are the programs where we feel that the return to society and to the individual would be greatest. We think it makes sense, for example, to provide nutrition programs for young children and for pregnant mothers, or immunization programs for young children. We know, that every dollar invested in those programs is going to save $3 or more down the line in terms of illnesses that are prevented by such programs, as well as keeping those individuals productive.

Within the guidelines of focusing and dedicating our primary attention to young children and pregnant mothers, we need to have a discussion on which programs are priorities and which might be reduced. We want to look closely and see which programs are not being utilized, are not effective, or have excess costs. We intend to reduce those costs or that excess capacity.

I think we would have to evaluate the programs within those guidelines, but the rationale of emphasizing young children and pregnant mothers really represents those commitments that we should honor first.

Mr. FORD. Are you saying that there is a commitment on the administration's part to increase under this flexibility freeze schedule that you show, with maybe six, seven different social programs, would, in fact, have a commitment from the administration?

Secretary SULLIVAN. Yes. President Bush has indicated his commitment to expanding the Medicaid eligibility to 130 percent of the poverty level. That represents one expansion.

Mr. FORD. That's under Medicare, a Medicaid program, right?

Secretary SULLIVAN. Yes.

Mr. FORD. Now, how will you identify? You said 130 percent of the poverty threshold?

Secretary SULLIVAN. Yes.

It is currently at the 100-percent level. That will bring a number of individuals into the Medicaid program currently not receiving benefits.

Some would like to go beyond that, and we would all like to do a lot more with a number of these programs. At the same time we have to face the reality of the budget deficit, because if we don't, we are going to have other difficulties in the future.

Another program that the President has committed to expanding is Head Start. He has proposed bringing all eligible 4-year-olds into the program, or into some similar program over time. The budget for this year has made a beginning.

Those are two examples of the kinds of programs we believe represent a good investment, where we need to honor those commitments.

Mr. FORD. One final question: Does the 130 percent reach any percentage of the goals of the number of indigent citizens that you are trying to touch or provide coverage under the Medicaid program?

I do not know what percentage of the indigent citizens are the women and the children that will be protected under the Medicaid program. Do you have any numbers on that, Dr. Sullivan?

Secretary SULLIVAN. I will be happy to get that information for you.

[The following was subsequently received:]

President Bush is committed to improving health care for lower income Americans by focusing first on populations most at risk, particularly mothers and their infants.

The Medicaid program serves nearly 26 million low-income adults and children. Almost 70 percent of Medicaid recipients are children or adults in families with dependent children. We estimate that we are currently providing care to approximatley 2 million low-income pregnant women and infants.

President Bush has proposed raising Medicaid eligibility to pregnant women and infants to 130 percent of the Federal poverty level. Eventually, when the proposal has been implemented in all States, we expect an additional 240,000 pregnant women and infants to be covered. Additionally, recent provisions of the Medicare Catastrophic Coverage Act and other legislation will make coverage possible for 300,000 more pregnant women and infants.

Mr. FORD. Again, thank you very much, Dr. Sullivan.

Chairman ROSTENKOWSKI. Mr. Downey will inquire.

Mr. DOWNEY. Thank you, Mr. Chairman.

Thank you, Dr. Sullivan, for your fine statement, and I wish you sincerely good luck, and I hope to be working closely with you on the implementation of a number of the programs that you have addressed. And I would like to talk with you about the welfare reform in a minute.

I have the privilege of serving as the chairman on the Aging Committee on the Human Resources Subcommittee there, and I would appreciate it if you would look into a draft report that is awaiting your review on the status of the Administration on Aging; and there is apparently in that draft report a recommendation to you to consolidate the Office of Aging with another agency.

If I could just presume, and make a political recommendation to you, the Aging Committee will go crazy at the idea of consolidating the Office on the Aging, and I believe it is contrary to the intention of Congress when it set up the Office on Aging, that it be consolidated.

If you would look at that, I would greatly appreciate it.

You listed in your statement that one of your highest priorities is to get the regulations on the welfare reform by the spring, and it would be my hope that you do that as soon as possible, and I am delighted that it is a priority with you.

One of the concerns that I shared with Mr. Darman this morning and that Mrs. Kennelly and others have, Mr. Ford is the father of the JOBS Program. We made a pact with the States when they—and especially the Governors—that there would be $800 million available in fiscal year 1990 for the operation of that program.

Now, Mr. Darman suggested to us that in a review with the States that only $350 million would be necessary in fiscal year 1990, but he further stated, and I would hope to hold you and him to this that, as States are able to put more people in the JOBS Program, that if more than $350 million is necessary, that your agency and his come up here with a supplemental so that we can make sure that the JOBS Program is funded at the level we promised the States.

I want to deal with a report that the subcommittee produced today. Now, you have not had a chance to review it, but I will be giving it to you before you leave.

Our subcommittee has done a report on the benefit levels for AFDC people, who receive AFDC across the country, and it points out, it is in the form of a report card, and we rank the States in their capacity to provide benefits in what they actually provide in the way of dollar amounts, and whether they provide emergency assistance in UP.

One of the disturbing aspects of this report is that a family of three in Alabama, for instance, when you combine their AFDC and food stamp benefits, a family of three is $346 a month, and in California a family of three has some $750 a month.

Do you contemplate anything, any initiatives to try to even out the level of benefits for children across this country so that we do not have the disparity that we now have between kids in some of the southern poor States versus kids in the west coast or the east coast where benefit levels are much higher.

These are the same children, they are all our children, but there is an enormous disparity in terms of what they get.

Secretary SULLIVAN. We are concerned about providing adequate services for young children. We will analyze this report and will provide comments to you as soon as posible.

There is a wide disparity in benefits, but at this juncture I really cannot say more.

Mr. DOWNEY. No, I understand that. I understand. You have not seen the report, and you are new to the Department, and there are a thousand issues there for you to examine, and I do not want to try to put you into any political trap. The normal answer I get from the administration is that we have got a budget deficit and that's a major concern.

But we provide SSI, supplemental security income for all our poor elderly and for disabled people, and children, and there is a minimum benefit that we guarantee, and it comes to about 75 percent of poverty for a single person.

Well, if you examine AFDC, you will find that we run the gamut from Alaska to Alabama, whether at levels below 6 and 7 percent of the States' median income, in some of the States. Many of us feel that there has to be a minimum benefit for healthy children, as well as disabled children, and any attention your administration could give to that I think would meet with widespread approval on this committee.

Lastly, let me just reinforce one thing that Mr. Stark said. In my State of New York, we have, especially on Long Island, the area I represent, we do not have excess capacity in our hospitals. We have a very, very different situation than in the rest of the country, where a couple of years ago, patients were put in hallways.

I would hope that, as you approach this whole question of regulation and reimbursement, that there be given some consideration to other parts of the country where we have very different problems in terms of capacity utilization and others.

Thank you, Mr. Secretary.

Secretary SULLIVAN. Thank you.

Chairman ROSTENKOWSKI. Mrs. Johnson will inquire.

Mrs. JOHNSON. Mr. Chairman, thank you very much.

I am very pleased that you are with us today, Dr. Sullivan, and I appreciate very much the comments that you have made and the interest that you have expressed. I am particularly pleased with your interest in addressing both the health care and educational needs of poor children and poor families; and, indeed, I think there is broad support on this committee and in the Congress to deal with those issues.

But, in my estimation, we cannot possibly deal with them if we do not do a more responsible job of looking at cost drivers in other areas, and if we can more honestly identify cost drivers in Medicare, I think we can do a better job in providing health care in a number of other areas as well.

And so, I would ask your assistance, along the line of my colleague from Ohio, in terms of the work with the current Commission, and focusing on some of the structural problems, possibly through the Commission, or possibly through gaining money in the next budget or in some way to do the research that I believe is necessary.

For example, one of the striking differences between the American health care system and England's health care system, or Canada's health care system, is in the intensity of care that we offer, and the intensity of interventions, particularly in late-in-life situations.

We do not even know the effectiveness of that kind of medical intervention, costly as it is. I think that we need more research on effectiveness, on some of those things to be able to look at that. What is the appropriate investment or level of medical intervention?

This is not just a cost issue. This is a humanity issue. It is inhumane what we do to some of our elderly in the last days of their lives. It is also one of the things that draws our limited resources away from empowering us to deal with the very important issues of health care for poor children.

There is not any way of getting away from the intergenerational competition for resources any more than there is the competition for defense versus domestic.

And so I think we need to really buckle down on the research that you need to better identify particularly the problems and issues and costs around this intervention issue, the appropriateness of the intensity that American medicine provides.

Second, on the capital reimbursements issue, has your Department looked at the fact that more than 50 percent of capital investments go to equipment costs?

Has your Department looked at competitive issue within the equipment industry? Is there price gouging? Does our liability system force a purchase of equipment, a replacement of equipment more frequently than, in a sense, science and quality of care issues can justify?

So, in the capital reimbursements issue, that matter of equipment and its implications for quality, of whether the equipment is being cost-effectively purchased, and whether liability issues are driving equipment purchases, are you all doing any investigation into that, and if so could you share it with us before we have to make serious decisions in the next few weeks?

Secretary SULLIVAN. Yes, thank you very much, Congresswoman Johnson.

On the issue of effectiveness, we fully agree with your concerns that we need to do more in terms of effectiveness and our research. There is an interest in our Department primarily in the National

Center for Health Services, and part of our Public Health Service, as well as interest in our Health Care Financing Administration, that we structure some research. I think we need to expand that effort so we can determine if the technology we are using has an effect, and, if so, how much of an effect. Thus, can we get more of a cost benefit, or ratio from that information?

We are aware that we spend a tremendous amount of our health care dollar in the last 3 weeks of life of our elderly citizens.

But, as you indicated, the question is whether or not some of the things we do are helping or not. We need to look at those questions more closely.

On the issue of capital costs and some of the factors in terms of equipment, we would have to provide that information to you. I do not know the answer at this time. I assume we have information in the Department. If we need to do more, we will certainly do that.

[The following was subsequently received:]

Medicare law mandates payment to providers for capital equipment on the basis of reasonable costs. Where appropriate, Medicare, like any prudent purchaser, encourages bulk purchases and discounts for volume. However, there are also situations where a "high tech" or "state-of-the-art" item may be available from limited suppliers and the provider may pay more for an item.

In applying the prudent buyer policy, Medicare fiscal intermediaries may employ various means to detect and investigate situations in which costs seem excessive. Techniques may include comparing prices paid by providers to the prices paid for similar items or services by comparable purchasers, spotchecking, and asking providers about indirect and direct discounts.

In those instances where an intermediary notes that a provider pays more than the market price for equipment or services, and there is no clear justification for the higher price, the intermediary must exclude excess costs in determining the allowable costs under Medicare.

Ms. JOHNSON. Dr. Sullivan, I see my time is up.

But if you would get back to me on the capital reimbursement issue and on what studies you are doing under this issue of appropriateness, of intervention; and, lastly, if you would get back to me on your rationale for cutting the reimbursements to Medicare contractors.

My contractors are saying to me, "You just passed the catastrophic health care, we are going to have a lot more work to do; we have got to implement a new law.

"And you are cutting our budget by 12 percent."

My hospitals are saying to me, "We had to go into the market and borrow $3 million just for cash flow. Now, we have got the interest on all that borrowing, and the cash flow problem is primarily due to late payments under Medicare."

So, I think we cannot afford to cut costs to our contractors until they can assure a flow of payments that does not impose useless borrowing charges on our providers.

Secretary SULLIVAN. Yes.

Mrs. JOHNSON. So, if you would get back to me with more detailed information about that, too, I would appreciate it.

Secretary SULLIVAN. Fine, we will be pleased to do that.

[The following was subsequently received:]

Our request for Medicare contractors fully funds those activities needed to implement the Catastrophic Health Insurance program. We also fund claims processing for the basic Medicare program to enable contractors to process an estimated 547 million claims within the timeframes mandated by the Congress. The speed with which contractors pay claims determines outlays from the Medicare trust funds. Most intermediaries (88 percent) are complying with the 14-day claims payment floor mandated in OBRA 87. The floor requirement resulted from the desire of the Congress to balance paying quickly (which improves cash flow to hospitals) against reducing overall outlays in a given year by paying slowly.

Chairman Rostenkowski. Mr. Matsui will inquire.

Mr. Matsui. Thank you, Mr. Chairman. I also, Dr. Sullivan, would like to welcome you here and also congratulate you on your appointment.

I would like to very briefly touch upon three areas, some of which have already been discussed. Mr. Downey raised the issue of AFDC benefits and the differences among the 50 States. California, for example, gives over $700 in benefits for a family of three on AFDC, mainly because of State supplements. And some Southern States are down to $375 a month in benefits. Frankly, I cannot imagine any family living on $375, a month even with additional noncash benefits that many families receive. For example, Medicaid benefits, which you cannot eat and you cannot take with you, and housing allowances.

I was hopeful that welfare reform would have dealt with the minimum benefit issue. We had in our House bill, if you recall, an enhanced benefit. That, unfortunately, was thrown out in the House-Senate conference, mainly because of opposition from the administration and some Senators opposed to any kind of benefit increase.

I am hopeful that in your 4 years or more as Secretary that you will really take a hard look at this issue because I do not think that only children in California should benefit. I think children from Mississippi and many other States should have the same advantages or opportunities as children in some of the Western and Eastern States. I think it is a critical issue; one that has to be addressed very shortly.

Let me move over to the issue of health care and the 37 million children and adults who either have no benefits or no opportunities for health care benefits. You talked about the 130 percent Medicaid threshold in response to a question from Mr. Ford. The problem with that is unless the Federal Government is willing to come up with the additional moneys, many of the States will complain that they do not have the wherewithal to take care of that increased population.

So, if the Bush administration supports, legislatively or otherwise, a 130 percent threshold instead of the current 100 percent required to qualify for Medicaid, are you going to be supporting an increase in the level of benefits at the Federal level for Medicaid, or are you going to depend upon the States to pick up that additional cost?

Secretary Sullivan. Thank you, Congressman Matsui. President Bush has proposed in his budget, compared to the budget proposed by President Reagan, an additional $1.4 billion for Medicaid.

Mr. Matsui. That only brings us back to the status quo, however, because the Reagan budget cut that from current services.

Secretary Sullivan. Yes, I am aware of that. We need to have participation by the States. This is a program that requires Federal and State participation. There is a responsibility that State governments have to their citizens. So, what the final mix would be, I cannot say. We certainly think that there is a responsibility that the States have that they cannot relinquish if we are to provide the services to the citizens.

Mr. MATSUI. I do not believe I got the answer I wanted, but I do not believe you can probably give me the answer I wanted. But let me move to the working poor, another segment of the 37 million Americans that do not have adequate access to health care. I do not believe President Reagan supported the Waxman-Stark-Kennedy legislation on mandated benefits.

What approach do you propose or do you believe the administration will propose, to provide health care benefits to those people?

Secretary SULLIVAN. At this time we are beginning to review this question. We are concerned about these 37 million people who are uninsured or underinsured. What the final shape of proposals will be, I cannot tell you at this time I feel confident that it is going to require broad participation because of the magnitude of the problem. It really is going to require Federal, State, and private sector initiatives to solve this problem, and because we are facing the kind of Federal deficit that we have.

Mr. MATSUI. I hope that the same kind of attention that will be paid to long-term care for senior citizens and refining the catastrophic bill for senior citizens will be paid to this group as well. As you know, the senior citizens are a very powerful constituency so they usually get close to what they seek. This group, however, has no effective lobby, so to speak. As a result, it is going to take leadership from the administration and certainly from your department.

Let me raise one other issue, but I will not ask for a response because I do not believe you can give me a response. The Michel amendment provided for error rates for AFDC benefits. We had to reduce State-by-State errors and the payout of AFDC benefits over a period of time. I believe that the Michel formula was flawed. It was one that really made no sense. It did not consider recessions, extenuating circumstances, and the kinds of errors that were used to calculate error rates.

That issue is now pending. The Federal Government, at least HHS in the last 6 years or so, has been seeking reimbursement from State governments because we have not attained the error rate levels under the Michel amendment. Today, 49 out of the 50 States are affected by the Michel amendment. In fact, the Federal Government is seeking about $250 million from the States.

I hope you are going to look on this in a kinder and gentler way than perhaps your predecessors did, because if this money is not available to the State governments, then they must, of course, reduce their AFDC benefit levels. I do not think we want to go in that direction. I just hope that when this issue comes up in the next few months you will be able to look at it perhaps a little differently.

Thank you.

Secretary SULLIVAN. Thank you. We will be looking into that, Congressman.

Chairman ROSTENKOWSKI. Mr. Levin.

Mr. LEVIN. Thank you, Mr. Chairman. Welcome, Dr. Sullivan.

Let me, if I might, talk with you further about the reimbursement for teaching hospitals. I think every one here looks forward to your leadership. Your intentions are very clear. Your statements of intention are just as clear. I think the real question the people have is the ability to translate intentions and language into record. Maybe there is a suspicion that all of us have, having been in politics and Government, that when money is very tight, talk tends to get longer.

So let us get down, if we might, to specifics. Not dollars, but specifics as an example of, I think, the dilemma that you face and that we face. The proposal, as you know, is for a major cut for teaching hospitals for medical education. The reason given, and you have referred to it, are the profit margins overall.

But here is the dilemma, I think. We had a hearing last week. PROPac came forth, and it was a very useful hearing. This was their testimony. I am reading from the report, but this was the gist of it. Major teaching hospitals had lower margins compared with both other teaching and nonteaching hospitals, while other teaching hospitals had the highest margins of the three groups.

So the dilemma is, if you lump them all together, the teaching hospitals, it is true you have a higher profit margin. But if you look at the major teaching units, hospitals, they have the lowest. In terms of a kinder, gentler nation, in terms of addressing the problems of children and the poor, the lower income groupings, the major teaching hospital, as you know better than I do, has a major function.

So essentially you are coming forth before our committee and our subcommittee saying that you want to focus on children and families that are more disadvantaged. Yet, the proposal would call for this major cut. It would be for major teaching hospital, an 8 percent cut. If you go into—I hate to use examples from my area because this is not provincial. There is a Ford Hospital in every major urban center that now has all the pressures from the 35 million uninsured that have been referred to, from the underinsurance of people, from the AIDS epidemic.

What we are saying to them is, because the profit margins of all teaching hospitals are greater than the average, though your margins are lower, we are going to administer to you a major cut.

Now how do you put that together with your statements of purpose?

Secretary SULLIVAN. Congressman Levin, that is indeed a difficult question. I believe that is the dilemma that we face and are trying to address. A commission in New York City chaired by Dr. Alfred Gelhorn recently made a report urging some changes in teaching hospitals, a medical school environment in that city. We need an increase in the number of primary care residency programs in those hospitals and a decrease in the specialty residency programs. Our major urban centers have a shortage of primary care physicians.

Primary care generally involves procedures that are much less expensive in terms of health care interventions than in the specialty areas.

We need to do more to promote the development of primary care physicians and primary care programs to hopefully reduce those catastrophic medical problems that the major teaching hospitals now confront along with prevention and health education programs. One of the reasons we know that this is the case is that in so many instances patients who come into those major teaching hospitals come in with severe problems which have not been addressed by anyone. They haven't been seen by the health care system until a near catastrophe or catastrophe has occurred.

What we are proposing are measures to enhance and promote more primary care physicians and programs and get away from the high-cost specialty care.

There is a lot to be done in moving from one to the other. We cannot do that overnight. It means a shift in the emphasis. The dilemma that we are faced with is if we were to continue with business as usual in those systems, we simply are compounding a high-cost system, an emergency type system that tries to rectify problems later rather than treating them earlier.

Take the problem of AIDS. We feel, for example, that we need to do much more for AIDS education and AIDS prevention activities because there we can have a real effect. We have seen in certain segments of our population the result of very effect educational programs. We need to learn how to spread educational programs to other parts of the population. If we can prevent AIDS, then indeed we are not faced with the patient who has AIDS on whom we spend $50,000, $150,000, or $200,000 for their care and still end up with a tragedy.

Those are some of the shifts that we are trying to make. But obviously, it is going to take a series of actions.

Mr. LEVIN. My time is up. We will be talking much more about AIDS because I think as vital as prevention is, we must also face the problems next year.

Chairman ROSTENKOWSKI. Mr. Coyne.

Mr. COYNE. Thank you, Mr. Chairman.

Mr. Secretary, do you think that as a nation we are overspending on health care? And in your opinion, is there a more efficient way to be spending the dollars that are available for health care in the nation?

Secretary SULLIVAN. Yes, Mr. Coyne, I think that there is no question that among the industrialized countries our health care dollars are taking a larger percentage of our gross national product than any other nation. When you look at the health status of our country, you find that in such things as infant mortality, rather than having the lowest rate, we are 16th or 17th among the industrialized nations.

We are spending the most, but in terms of results, we are not getting what you would expect. That suggests that we need to find different ways of addressing the health care needs of our population. That is one of the reasons that we are looking to emphasize more health education, more prevention, more care for infants, children, and pregnant mothers where dollars spent can have greater impact in terms of future health of those individuals as well as saving of dollars in terms of future costs.

If I might just give one quick example of the kind of thing we are talking about. When I was a medical student in Boston back in the mid-1950's we had our last polio epidemic. As a third-year medical student, I spent time putting patients with paralytic polio into and out of iron lungs so that they could stay alive. The number of personnel involved in caring for those individuals and the cost of those iron lungs was tremendous.

Now polio hardly exists. The reason for that is that we have developed a polio vaccine with the work of Dr. Thomas Enders at Harvard Medical School and others. Now for just a few cents we give a polio vaccine to a young child and prevent tens or hundreds of thousands of dollars having to be spent later, as well as maintaining that individual as a productive citizen rather than being an invalid who may require tremendous resources from the public or private sector.

What we want to do is emphasize more programs to try and keep people healthy, and to prevent disease while still continuing research into better ways of finding treatments as well as providing care for those individuals who have illnesses. We are not going to eliminate illness by any means, but we can do a much better job.

Mr. COYNE. As you know, in the last several years, health policy has pretty much been developed at the Federal level by looking at the deficit. We look at the deficit and we say, we can only spend this much for health programs. So we are guided by the deficit figures that exist in the country today.

I just wonder, in your judgment, if that is a very good way to be determining what health initiatives we make as a nation.

Secretary SULLIVAN. No, Congressman Coyne, I certainly would agree with the implication in your question that we need to have a more rational way of making decisions concerning health expenditures. We also need to have more long-range planning for our health system and not simply have day-to-day or year-to-year planning. We need to develop a comprehensive long-range plan for what should comprise our health system and work towards that once we have reached a consensus.

Mr. COYNE. And it ought not to be driven by deficit considerations.

Secretary SULLIVAN. We need to be mindful of the deficit, and we need to have a system that is more cost-effective and hopefully less expensive. We have to be mindful of the dollars that we are spending. But if we can have a much better planning system, for our health system, eventually we will have lower costs and a more rational system.

Mr. COYNE. As you know, there have been proposals to tax employee health benefits. I just wonder what impact you think that might have if we were to tax employer-paid health benefits on medical care in the nation.

Secretary SULLIVAN. I will consult with my colleagues in the Department and insert an answer in the record. What we should be doing is providing incentives to encourage individuals to purchase and get adequate health care. I would be concerned if there turned out to be a disincentive there.

[The following was subsequently received:]

Employer-provided health care is a form of employee compensation that, for historical reasons, is not taxed like other income. Two arguments have been made over the years about this special tax preference.

As a subsidy to the purchase of health insurance, the exemption may have encouraged excessive "first-dollar" insurance coverage which has been a key factor in driving up health costs for the past decade.

Considering tht employees lacking employer-sponsored health insurance must buy their own coverage with after-tax dollars (if they can afford it), and that self-employed individuals can deduct only 25 percent of their health insurance premium, the 100 percent exclusion must be viewed as highly inequitable. Moreover, while the highest-paid employees tend to gain the most from this preference, all earners, including those without coverage, must pay higher taxes to make up the lost revenue.

These observations do not imply that the tax exemption should be eliminated. Placing a limit on this exemption was proposed, as you know, by the Reagan administration.

Mr. COYNE. Thank you very much.

Chairman ROSTENKOWSKI. Mr. Moody.

Mr. MOODY. Thank you, Mr. Chairman. Dr. Sullivan, welcome to the committee. We certainly look forward to working with you. All of us wish you the best in your new assignment.

I want to make three brief points. One is a philosophic point, and you can respond to that and then I will go on to the others. We heard Mr. Darman this morning outline the priorities for this administration. Among the absolute top-of-the-list priorities was the maintenance of Social Security and benefits for the elderly. There is also the so-called black box component of the Darman budget, which is far less sturdily defended. As you know, the priorities within that are purely up to negotiation, include things that affect the health of children.

It seems to me one would be hard-pressed to make a moral case that the health of senior citizens is more important the health of children, particularly since, as we know, one out of five children are born in poverty and will remain in poverty through their entire childhood with all the ancillary deprivations and access to adequate health care that that poverty status implies.

So I would hope you would elevate, if you will, the health of children in this society, who have no powerful senior citizen lobby to speak for them, to fight for them. I am not downgrading the importance of senior citizens, only that the children also need to be given comparable priority in health care. If anything, on a dollars and cents basis—though that is not the only way we make these decisions—a dollar invested in the health of a child has more of a multiplier even than the dollar invested in the health of an adult.

So if we are looking at productivity and long term cost beneficial calculations, certainly I cannot think of anything much more important than health of children. I wonder if you would comment. I do not have much time, so I will ask for a brief comment.

Secretary SULLIVAN. First of all, I am sure that Mr. Darman was referring to the contractual obligations that we have in terms of the Social Security system, and those are commitments that have been made which should be honored. I agree with you that we do need to focus on the limited resources that we have where they can do the most good. I fully agree that the health of our children is a concern that we have in the Department, and President Bush has articulated this. We intend to work with him to provide leadership to address the needs of children.

Mr. MOODY. Thank you, I appreciate that assurance. Now on two rather not quite so global points. Your proposal outlines a freeze in MEI for nonprimary care physicians. Now if past history is any guide, we might well expect to see an increase in volume as a reaction of that step. Can you give us any assurances that there is a way to head that off as a way of wiping out those gains that would otherwise be made, because we have seen that in the past?

Secretary **Sullivan**. That is a complex question. Part of the answer is the effectiveness research that we were discussing with Congresswoman Johnson, to show whether or not those procedures are effective. Another part is case management as well to have strong controls on utilization.

As you know, the Hsiao study has identified a number of procedures which are clearly overpriced. We will do everything that we can to minimize overutilization of those procedures because of their cost as well as the questionable benefits.

Mr. **Moody**. Thank you. Another element driving or rapidly expanding inside the Medicare budget has, of course, been diagnostic testing and other ancillary services. That component has been literally exploding. We have also heard that it is difficult for the fiscal intermediaries and carriers to review claims for accuracy and appropriateness. This is no easy task.

Now in that light, I am very disturbed to see that there appears to be inside the budget a 35 percent reduction in funds for precisely these kinds of anti-abuse operations. We know that those dollars, Dr. Sullivan, spent on anti-abuse pay for themselves many times over. One GAO study that was reported in the Senate said that for a fiscal year 1988 outlay of only $305 million, Medicare actually saved $4.3 billion. So every dollar spent in that component of the budget yields many, many dollars of savings overall.

Since you are proposing a 35 percent reduction in those particular anti-abuse control funds, can you justify that? Is that not something you might want to take another look at?

Secretary **Sullivan**. Congressman Moody, I can assure you we will review that and determine if adjustments should be made. We are concerned both with saving dollars that are not necessary, as well as exposing patients to the dangers of unnecessary procedures. That specific detail of the budget did not come to my attention. We will look at that and insert a response in the record.

[The following was subsequently received:]

Given the severe constraints placed on the budget by the Gramm-Rudman targets, it was necessary to target certain activities that are of lower priority for reductions while funding activities of primary importance. To stay within these tight constraints, the budget assumed that claims processing and implementation of the Catastrophic health Insurance program were of primary importance, even at the expense of audit or other payment safeguard activities.

Mr. **Moody**. I would just make an analogy to the S&L's where we saved money on auditors and later it turned out we lost a lot of money later. This may be analogous because these dollars yield more than 10 to 1 savings for every dollar spent. Thank you.

Secretary **Sullivan**. Thank you.

Chairman **Rostenkowski**. Mr. Guarini will inquire.

Mr. **Guarini**. Thank you, Mr. Chairman. Dr. Sullivan, we wish you well in your most important post. You have got great responsibilities and that carries with it also some interesting and high challenges.

I imagine everyone is looking for new directions. Everyone realizes that their coverage is not total. Many people go without proper medical coverage and care. You say we spend more money than any other nation and we have the least results. It seems to me that there is something very wantonly missing.

I am just wondering where you think the abuses are. I know there perhaps are areas that have to be cleaned out and tightened up and the fat cut and abuses taken out of the process. Can you identify some of the areas that we have to examine?

Secretary SULLIVAN. Yes, I can, Congressman Guarini.

I think that we fail as a nation in preventive health services. Our health care system is oriented primarily towards remedial care. We have not appreciated and acted on the fact that by investing time, effort, and dollars into preventive programs, we can keep our population healthier. Better prenatal care and access for all to prenatal care is an example?

Prenatal care reduces the incidents of premature labor and delivery, of small birth-weight babies with their high incidence of complication and immunizations. There are a large number of our young people who, in spite of having great medical research establishments, still do not get proper immunizations, et cetera.

Mr. GUARINI. Other industrialized nations do much more preventative medicine than we do.

Secretary SULLIVAN. And are much more effective in reaching their population.

Mr. GUARINI. What about nutrition also. Other industrialized nations do more for their people regarding nutrition than the United States does, like WIC and other programs that we have.

Secretary SULLIVAN. We have gaps in our population in providing adequate nutrition.

Mr. GUARINI. You know, it is so easy to spend all of our time dealing with numbers and dealing with programs, instead of dealing with creative and innovative thinking, and I should imagine that we are at a crisis point now. We have got to talk about new directions.

I imagine that your department will spend some time in trying to put together new types of programs so that there would be more total coverage. You are committed to look into new areas, and not be shy about experimenting in these areas, is that correct?

Secretary SULLIVAN. That is correct, Congressman Guarini. One of the guiding principles of health promotion is really working with individuals and populations so that they actually are self-empowered to believe that there are things that they can and should do to maintain and enhance their health. We have not done a good job in that. That is part of an overall strategy for increasing individual responsibility in our population.

Mr. GUARINI. The same time the existing programs we have, I was on the executive committee of the second oldest hospital in my State, New Jersey, Christ Hospital. It has been a very fine run hospital, well over 100 years old.

I got a call from the business administrator. They are at the point of almost closing their doors because for the first time they find themselves unable to make it financially.

I imagine that this problem is being repeated all across the Nation. That is what causes us great grief when we start cutting part A larger and in great measure as we have, because it is not only teaching hospitals that take a hit, but all hospitals. If they are at a straining point, it is that last straw that breaks the camel's back.

Is there any backup or contingency plans for hospitals like Christ Hospital, in the event they get into a tight cash flow basis, and have to close their doors?

Secretary SULLIVAN. We would need to look at the circumstances of that individual hospital. One of the problems that we face with our hospital systems is that sometimes I think we have had wanton spending by our various hospitals—where hospitals within short distances of each other have competed in acquiring very expensive equipment such as magnetic resonance imaging machines.

Mr. GUARINI. But they can double off and share laundry services and other equipment.

Secretary SULLIVAN. Yes.

Mr. GUARINI. Let me just, in my remaining time, go on to AIDS. I understand that Medicaid pays for 40 percent of the AIDS patients, or 25 percent of the AIDS cost in our country. We have that based on 75,000 cases, which we expect in 1992 I understand to catapult to 365,000 cases. That is an increase of four or five times.

I am wondering what contingency we have to take care of this kind of a situation. Certainly, the money is not in the budget. We know that that is going to be a catastrophic situation that is going to occur very shortly. What backup plan do we have when this onrush of new AIDS cost comes into our budget process?

Secretary SULLIVAN. Congressman Guarini, we have increased the funds for AIDS in the President's budget by approximately 24 percent, which is one of the largest proposed increases in his budget.

Mr. GUARINI. But it is still small, when you consider the magnitude of the problem.

Secretary SULLIVAN. Yes. If you review the past 3 or 4 years, the funding for AIDS has increased quite significantly. For example, the Public Health Service's budget for AIDS has increased from $1.3 to $1.6 billion in the President's budget. When you add in spending for AIDS treatment, the total is over $2 billion for the Department. To that you add spending by the States.

So certainly I would agree with you that this is a major problem, and we need to find ways to do more—both to take care of those individuals who have been infected with the virus, but equally important to undertake measures to halt the spread of the virus to other individuals in the population.

This is a crisis that needs to be addressed, and we are addressing it in the Department by that magnitude of the budget. From the standpoint of AIDS research, we have had a remarkable number of developments through the activities of the National Institutes of Health.

We do not have a breakthrough in terms of a vaccine or a cure, but we have evidence that some of the patients treated with AZT are living longer. We have other treatments that we are testing, and hopefully they will be even more effective.

This is an evolving picture, but we do not have the final answer. We are concerned about AIDS and are committed to doing whatever is necessary to stem the epidemic.

Mr. GUARINI. Thank you. Good luck in your endeavors, Doctor.

Chairman ROSTENKOWSKI. Mr. Rangel will inquire.

Mr. RANGEL. Welcome, Mr. Secretary. I feel good that you have joined the administration while it is going into a kinder and more gentle mode.

The last 8 years, I have not been able to find in your office any semblance of a drug rehabilitation program. I know for 8 years the war has been conducted, but have you found anything that you can evaluate in terms of, say, one Federal rehabilitation program that was considered or offered to the Congress, or in existence? Was any of that shared with you?

Secretary SULLIVAN. Yes, Mr. Rangel. The President's budget proposes about $1.1 billion for drug treatment, research, and prevention. There is a program, I believe around $50,000, for a drug treatment program.

Mr. RANGEL. Will that be a Federal program or is this an increase in the block grant?

Secretary SULLIVAN. I will have to get that information back to you.

[The following was subsequently received:]

This is a drug treatment waiting list reduction program for approximately $75 million and is a Federal program.

Mr. RANGEL. What I am trying to say is that I am talking about cost containment now. I am not talking about additional dollars. I just want to know with the President now putting on his agenda, treatment for addicts, it seems to me that now we may have a criteria as to what treatment is effective, what treatment does not work, whether the Federal Government should be supporting methadone, whether the costly hospital treatment of $500 and $600 a day is really working. Whether or not doctors are coming into highly addicted communities and setting up Medicaid mills and are reimbursed for mind-altering drugs.

During the last 8 years, the mode was it is a local or State problem, so all we did was appropriate money and shove it to the Governors in block grants. When the President says that this is a priority with him, am I correct in believing that this means now there is going to be a Federal criteria, there is going to be oversight, there is going to be a policy, that I can find out now from my Federal Government which modality they think works, where the ripoffs are now.

I am not talking about additional money because for the last 8 years, if you were talking about housing or education or prevention or treatment, the whole idea was that is local and State. Is it now Federal, Mr. Secretary?

Secretary SULLIVAN. Mr. Rangel, I can assure you that President Bush and I both consider this a major national problem. This is a problem that affects our youth. It is robbing us of our future as a nation. It is a national problem.

This requires Federal leadership. As you know, the President has appointed Dr. Bennett to coordinate the overall drug prevention effort, and we will be working with him closely. It requires active leadership from the Federal Government, and I intend to be part of that leadership.

But it also requires participation by our State governments and the private sector, because we are dealing with a tough problem. We seem to be making minute advances, whereas we need to be making major advances, and we want to get our best minds focused on the problem of how we provide both the best treatment facilities as well as the best preventive programs. Drug use is intertwined with so many other problems.

Mr. RANGEL. Let me ask you to pause, Mr. Secretary, because I agree with you 100 percent. I just want you to tell me where I am right or wrong, and that is for the last 8 years, I have not been able to identify any person in your Department that has developed the expertise in dealing with drug treatment, so that I could get information as I monitored local, State and private sector programs.

Was there an agency or a person in your Department when you got there and who will that person be, now that you are there?

Secretary SULLIVAN. That agency is the Administration for Drug Abuse and Mental Health. There are several divisions within ADAMHA, but that is headed by Dr. Frederick Goodwin. About 1 week ago, Dr. Goodwin reported a study funded by the Department that showed, for the first time, evidence of a fall in the incidence of new users of marijuana and other drugs.

Mr. RANGEL. Doctor, I know about that report, and it did not take into consideration the kids were not in school. What I am talking about is treatment. I do not know whether methadone is working. I do not know whether the drug-free programs are working. I do not know whether the Medicaid programs, where these doctors in my community practice are working. There are no Federal rehabilitation programs that I can go to in order to determine what is working.

I am just asking are we talking about your office just putting money out there for the governors and the mayors and the private sector, or are we saying that at some time your office will be able to share with the Congress your ideas as to what programs we should be supporting, what programs do not work, and what programs you will be asking for support for?

I mean, I do not know.

Secretary SULLIVAN. Congressman Rangel, we are very much concerned about our ability to answer the questions that you are raising, and we have Dr. Goodwin and his colleagues to work with us. We must have the answers to questions, on effective therapies.

I think it is fair to say that where there are some therapies that have some effect, such as methadone maintenance therapy, none of us is satisfied with what is available. We need to devote more effort in our research to find better therapies.

Mr. RANGEL. I welcome the Federal presence and I wish you all the luck, and you have my support in that endeavor.

Welcome.

Secretary SULLIVAN. Thank you.

Chairman ROSTENKOWSKI. Thank you, Dr. Sullivan. You have been most helpful.

That concludes the meeting of the committee. The committee will stand adjourned until 10 o'clock tomorrow morning.

Thank you again, Doctor.

Secretary **SULLIVAN**. Thank you, Mr. Chairman.

Chairman **ROSTENKOWSKI**. Good luck.

[Follow-up questions to the Secretary and his responses follow:]

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COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
WASHINGTON, DC 20515

March 13, 1989

The Honorable Louis W. Sullivan
Secretary
U.S. Department of Health and Human Services
200 Independence Avenue, S.W.
Washington, D.C. 20201

Dear Mr. Secretary:

It was a real pleasure to have you come before the Committee last week. I appreciate your willingness to be honest and frank with the Committee in discussing the budget issues that fall under both of our jurisdictions.

The issues discussed at the hearing have brought up some further questions. We would appreciate it if you could answer the following questions to be included in the record:

1) The Reagan Administration cut the staff of the Social Security Administration by nearly 20 percent between 1984 and 1989. As a result, services to beneficiaries have been jeopardized and employee morale is at an all-time low. It is our understanding that Commissioner Hardy has recommended to you and the President that SSA staffing be stabilized. Do you intend to accept her recommendation and stop these harmful staffing cuts?

2) In order to be eligible for social security disability benefits, an individual has to be unable to engage in "substantial gainful activity" (SGA). SGA is currently defined by regulation as the ability to earn $300 a month or more. That $300 limitation has not been increased since 1980 and is badly in need of an increase. The Social Security Disability Advisory Council recommended an increase to $490 - with indexation thereafter - to reflect average wage growth since 1980. It is my understanding that discussions are under way within the Social Security Administration with a view to increasing SGA. Would you support an increase? If so, to what level and when?

The Honorable Louis W. Sullivan
March 13, 1989
Page 2

3) President Reagan's budget included a number of cuts in human resources programs. It is unclear whether President Bush has endorsed these proposals.
- Is the funding for the JOBS program included in the programs subject to a freeze?
- Are you still proposing to cap State welfare administrative costs?
- Are you still proposing to reduce child support incentive payments?
- Are you still proposing to cap foster care and adoption assistance administrative and training costs?

Thank you for taking the time to respond to these questions. Throughout the year the Committee on Ways and Means will be working very closely with the Department of Health and Human Services on many issues. As Chairman of the Committee, I look forward to working with you.

With warm regards, I am

Sincerely,

Dan Rostenkowski

Dan Rostenkowski
Chairman

DR/wpl

THE SECRETARY OF HEALTH AND HUMAN SERVICES
WASHINGTON, D. C. 20201

[illegible]

The Honorable Dan Rostenkowski
Chairman
Committee on Ways and Means
House of Representatives
Washington, D.C. 20515

Dear Mr. Chairman:

This in response to your letter requesting additional information following my appearance before your Committee. Enclosed you will find answers to the questions you raised.

I look forward to working with you regarding issues of mutual concern affecting the programs of the Department of Health and Human Services.

Sincerely,

Louis W. Sullivan

Louis W. Sullivan, M.D.
Secretary

Question 1:

The Reagan Administration cut the staff of the Social Security Administration by nearly 20 percent between 1984 and 1989. As a result, services to beneficiaries have been jeopardized and employee morale is at an all-time low. It is our understanding that Commissioner Hardy has recommended to you and the President that SSA staffing be stabilized. Do you intend to accept her recommendation and stop these harmful staffing cuts?

Answer:

From fiscal year 1984 to fiscal year 1988, SSA did reduce its full-time equivalent (FTE) requirements by about 16 percent. Over the next two fiscal years, 1989 and 1990, I expect SSA to reduce FTEs by another 5 percent, for a total reduction of 17,000 FTEs. However, between 1984 and 1988, surveys by the General Accounting Office and the Office of Inspector General of the Department of Health and Human Services showed that the percent of the public rating SSA service as "good to very good" has remained consistently high.

SSA has been able to achieve employment reductions and service improvements through management initiatives and by reducing or eliminating manual processes through the use of automated data processing and modernized telephone systems. Accordingly, an agency that once relied on a very large work force, now has a smaller, more efficient work force. It is important to note that the employment reductions have come about through normal attrition.

It is normal that such a major transition would be marked by a period of uncertainty and anxiety among employees and management. Indeed, that has happened at SSA. However, I believe that SSA's employees are SSA's most valuable asset, and I am committed to easing the adjustment to a new operating environment.

I expect that after the 17,000 FTE reduction is completed in FY 1990, and with modernized service delivery systems in place, SSA's staffing levels will stabilize.

Question 2:

Do you support an increase in the substantial gainful activity (SGA) level, and if so, what level do you support, and when will the change be made?

Answer:

Knowing that inflation has affected the value of the current SGA amount, I am exploring regulatory changes that would be consistent with the program of the President.

Question 3:

President Reagan's budget included a number of cuts in human resources programs. It is unclear whether President Bush has endorsed these proposals.

-- Is the funding for the JOBS program included in the programs subject to a freeze?

-- Are you still proposing to cap State welfare administrative costs?

-- Are you still proposing to reduce child support incentive payments?

-- Are you still proposing to cap foster care and adoption assistance administrative and training costs?

Answer:

Under President Bush's proposed FY 1990 budget, we have requested $350 million for the JOBS program. We believe this amount, which agrees with the Congressional Budget Office estimate, will provide sufficient funding for those States implementing the JOBS program in FY 1990. Should this amount be inadequate, we will ask the Congress for a supplemental appropriation.

The legislative proposals to cap State and local welfare administrative costs and to require increased State performance levels as a prerequisite to child support enforcement incentive payments fall within the programs in President Bush's designated residual freeze category. Therefore these proposals are subject to the outcome of negotiations between the Administration and the Congress on the whole FY 1990 budget plan.

The foster care and adoption assistance legislative proposal was not explicitly mentioned in the budget submitted by President Bush. The President has made adoption a priority and the Department will be examining all activities that affect this process.

[Whereupon, at 3:53 p.m., the committee was adjourned, to reconvene at 10 a.m., Wednesday, March 8, 1989.]

THE BUDGET DEFICIT, THE STATE OF THE U.S. ECONOMY, AND FEDERAL BUDGET POLICY FOR FISCAL YEAR 1990 AND BEYOND

WEDNESDAY, MARCH 8, 1989

House of Representatives,
Committee on Ways and Means,
Washington, D.C.

The committee met, pursuant to notice, at 10 a.m., in room 1100, Longworth House Office Building, Hon. Dan Rostenkowski (chairman of the committee) presiding.

Chairman Rostenkowski. The committee will come to order.

I want to apologize for being late.

This morning we will hear testimony on the Bush budget package from our third administration official. We welcome Michael J. Boskin, Chairman of the Council of Economic Advisers to the committee.

Mike, you are no stranger to this committee. You have testified before us on many occasions, plus you have provided advice of the Council to this committee as a faculty member at several of our committee retreats.

We look forward to working with you in your new role as the Chief Economic Adviser to the President.

Reducing the Federal deficit should be the highest domestic priority for Congress and the administration. One of the foremost concerns in putting together a deficit reduction package is that we use realistic economic assumptions. We do not want unpleasant surprises later as a result of being overly optimistic and using blue smoke and mirrors to achieve temporary paper savings.

I realize that you have played an instrumental role in developing economic assumptions using the President's budget. However, I have a hard time believing that if you were planning long-term investment for a private corporation or even for your own family that you would not count on interest rates falling to 3 percent in 1994. Even in the short run it seems unrealistic that interest rates, now at 8.5 percent and climbing will fall to 6.5 percent by the end of this year.

A significant real deficit reduction package should drive interest rates down. However, the decline will be modest; not 2 percentage points by the end of this year, or a miraculous 5 or 6 percentage points by 1994. Furthermore, many economists believe that real growth of over 2.5 percent a year would yield substantial inflationary pressure.

Mike, we are willing to negotiate with the administration fairly, justly, and honestly, but I also believe that includes being realistic in using realistic economic assumptions. Otherwise our problems will be back to haunt us next year, and if they come back next year they are going to be worse than they are this year.

I believe that we have—and I suggest that the entire committee joins me on this—a formidable task in front of us. Mr. Boskin, I look forward to working with you, and the committee, I am sure, looks forward to working with you as well, and right now we are looking forward to your testimony.

Mr. Archer.

Mr. ARCHER. Thank you, Mr. Chairman.

Dr. Boskin, I am particularly glad to have this chance to welcome you to our committee in your maiden voyage, as it was.

I want to say again how pleased I am that President Bush elected you to be Chairman of his Council of Economic Advisers. You and I have worked together on a number of occasions, and I have also followed your work for many years, as you know, and I am certainly comfortable with you on the position that you hold.

I know that those of us that serve on this committee realize all too well that the science of forecasting short and long term economic trends is an inexact one, and renowned economists often look at the same set of data and come up with completely different conclusions.

You will, no doubt, hear that some members of this committee believes that the administration's economic assumptions to be overly optimistic. In fact, the chairman just alluded to that.

In the end, however, those assumptions will and likely in fact, likely form the basis for whatever we do in meeting our deficit reduction goals for the coming fiscal year. Certainly it is healthy for us to explore the issues involved with you and I hope that all of us can approach the subject with an open mind.

I thank you for coming before us. We have a dawning challenge ahead of us. I welcome your testimony and the opportunity to exchange ideas with you.

Mr. BOSKIN. Thank you very much, Mr. Archer.

Chairman ROSTENKOWSKI. Any other member would like to make a comment?

[No response.]

Chairman ROSTENKOWSKI. OK, Mike.

STATEMENT OF HON. MICHAEL J. BOSKIN, CHAIRMAN, COUNCIL OF ECONOMIC ADVISERS

Mr. BOSKIN. Thank you, Mr. Chairman.

Chairman Rostenkowski Representative Archer, and other distinguished members of the committee and, if I may say, friends or at least colleagues from long-standing testimony and faculty advice I have given at the Ways and Means retreat.

It is a pleasure to appear before you today to discuss President Bush's economic programs, about economic outlook in relation to the budget.

Let me say that the Ways and Means Committee will be instrumental in dealing with the budget deficit problem. There are numerous parts of the budget that fall directly within the jurisdiction of the committee in addition to the obvious one that the public recognizes on the receipt side, for example numerous entitlement programs.

Today what I would like to do is to summarize briefly the basic thrust of the President's economic policies. I would like to say a few words about the economic outlook and some budget issues of interest to the committee, and then I would be happy to answer further questions.

You heard from Budget Director Darman yesterday, and I will not, in my opening remarks get into details of the budget proposals, and you will hear from Secretary of the Treasury Brady tomorrow. He is not only the chief economic spokesman for the administration but also has line responsibility for the receipt proposals. I will say some general remarks about that, and will be happy to take questions, but I think it would be unfair to him for me to get into elaborate details on the receipts proposals, although I would be happy to discuss them in the question and answer.

Let me start by laying out the basic framework of the administration's policies since obviously budget policies are but one part. It is an awfully important part, perhaps the most important part, but we would not like to see the economic health of the country undermined by policies outside the budget area which could cause us problems.

The administration's economic goal primarily is to promote further economic growth in rising incomes to American families. To do that, to extend the current economic expansion without accelerating inflation. Hence, there are four primary components to the administration's plan for achieving that goal.

First, and let me emphasize the subject of our discussions this morning, the number one priority must be to reduce the Federal budget deficit substantially, steadily and predictably. We have said, and I will repeat here we stand ready to enter negotiations with the Congress to achieve that end, and I will have some more remarks to say about it.

I believe it is imperative that we get a substantial, credible deficit reduction package negotiated and in place promptly. I will come back to that in a moment.

The three other components against which form the backdrop for the performance of our and the world economy are: number 1 for the United States to lead the world to freer and fairer trade. I emphasized both of those words: free and fair. A primary focal point will be through negotiations in the Uruguay round of the General Agreement on Tariffs and Trade. We must not and will not allow unfair trade practices to continue, but we must realize that we must resist the temptation to degenerate into a trade war. That is the surest way to throw our and the world's economy into a recession.

Third, the administration believes a substantial part of the health and vigor of our economy is because of its flexibility and dynamism to adopt the changes, to generate new jobs in a changing world environment. And that to continue that flexibility and dynamism will necessitate a voiding of unnecessary regulation.

Fourth, the administration supports the monetary policy which predictably controls inflation. I say in my written remarks, and let me repeat here, in recent weeks much has been made of alleged differences between the administration and the Federal Reserve. I can assure the members of this committee that more—pardon me—that a mountain is being made of much less than a molehill. The administration and the Federal Reserve share the goal of containing, and of eventually reducing inflation, and we both also seek equally sustained economic growth.

Let me turn my attention to the issues of most importance—direct importance to this committee: deficit reduction.

Reducing the Federal budget deficit is the surest way to raise the current low rate of national saving in the United States. The national saving is the sum of what the private sector, the business sector, and the household sector saved, and what the Government units of the United States, local, State, and Federal, contribute to saving. If they ran a balanced budget that would be zero. If they ran a surplus they would be contributing to saving, but by borrowing—heaving borrowing in the Federal Government, slight surpluses in the State and local sector—they are draining resources away from private savings so that our national saving is below private saving, and we have far less resources available for productive investment than we otherwise would.

Now, if we go back to the 1960's and 1970's and compare the decline in the national saving rates of today, the majority of that decline has been due to the decline in the conventionally measured private saving rate, and a minority—although it has gotten most of the attention—to the increase in the Federal Government budget deficit.

However, we do not yet possess a confidently precise estimate of the causes of changes in personal saving, and hence it is difficult to develop policies to change personal savings and behavior.

We must be especially careful—and I would urge this committee to be on guard—not to adopt policies, which while potentially able to raise private saving, do so at the expense of an increase in the budget deficit, for that would just be transferring the problem of our low national saving rate from the private even more so to the public sector.

So, therefore, we must focus on reducing the Federal deficit as the most effective way of raising the national saving rate.

The Gramm-Rudman-Hollings targets—a balanced budget—by fiscal year 1993, and it is economically desirable not only to meet the targets in Gramm-Rudman-Hollings but thereafter to run a unified budget surplus on average.

The deficit must be reduced in a way that it does not reduce private saving as I just noted for that just reshuffles the problem for low national saving from the public sector to the private sector. We also need to be wary of reducing productive Government investment in our future. The reduction in Government borrowing or dissavings should come from slowing the growth of Government consumption.

Now we have seen an inflow in the mid to late 1980's—a substantial inflow of foreign capital. That has occurred for a variety of reasons partly because the U.S. economy is strong and safe. People are not worried about having their funds expropriated or a quarter of the entire world economy, and there are a many reasons for foreigners to invest here. As foreign countries liberalize the allowable investments of their institutional investors, their insurance companies, and their pension funds, it is natural for some of that to flow to the safest, largest economy which is the quarter of the world's economy.

Some of it has been lured in or sucked in because of our low national saving rate. There are only 2 possibilities if our modest level of investment is given, say, by the level of my left hand to give a simple visual analogy, and we are saving about that much privately if the Federal Government borrows, and if there is an imbalance only two things can happen, either investment has to fall or the difference must be made up by some other financing which has been foreign capital to some extent in the 1980's.

It is my own opinion that such flows will continue for some time, but it would be imprudent to leave in place low national saving which causes us to rely on the indefinite future—on continued flows of foreign capital. We should be saving more as a nation, and that certainly will reduce the net need for foreign capital.

Let me also say that large Federal deficits have various ways in which they contribute to our trade deficit. High rates of Government spending and private consumption, raised domestic demand above domestic production, imports making up the difference.

But in addition to these economic factors, which I have stressed for getting the deficit under control and which—I know from previous conversations with members of the committee are well-known to you—there is an ethical or moral dimension as well. We should not be leaving future generations a larger public debt burden, perhaps best measured relative to their likely income, unless we also leave them more public or private assets.

Let me say a few words about improving incentives in equity. The Tax Reform Act of 1986 was an historic achievement and obviously in no small measure due to the members of this committee. The Nation is a beneficiary of many of the changes made in that act, of which the most significant was the substantial reduction in marginal tax rates, which made the Government a much smaller silent partner in innumerable economic decisions.

However, obviously no single act when—one that is that comprehensive—can achieve all goals, and there are areas where the administration believes further improvement can enhance incentives of inequity, and there are a variety of proposals in the President's budget proposals.

For example, there are a variety of proposals that are designed to improve initiatives to raise investment and productivity. Among these are desires to encourage long term investment in both human capital and tangible capital and others to expand and to enhance our research efforts. For example, making the R&E tax credit permanent, changing its allocation rules, capital gains tax proposal, spending initiatives in human resources in education, and in science and technology.

I will not go into great detail, but let me just indicate a few things about the capital gains proposal and the R&E tax credit that may be of interest to you.

First of all we know that during this expansion, a large share of the increase in jobs has been in small and medium sized firms. The administration would like to improve the environment for entrepreneurship in a carefully designed manner. We know that high tax rates on capital gains reduce the returns to saving, investment, and risk taking in entrepreneurial activity.

They also lock in inefficient investment, preventing capital from moving from lower to higher productivity uses thereby significantly reducing realizations and reducing revenue.

We believe a lower tax rate on capital gains would reduce the taxes paid on purely inflationary gains, will help off-set the current tax bias against corporate equity, and improve the United States and international competitive position since most of our major trading partners tax capital gains lightly if at all.

There are variety of other arguments one could make in favor of the capital gains proposal, and I know there is some dispute about the proposal, and I know there is some dispute about the likely revenue effects, which I would be happy to deal with in the question and answer period.

In addition to the capital gains proposal we have an R&E tax proposal which we believe is desirable to enhance our ability to generate and expand new industries and new products and enhance our competitiveness.

There are also some energy tax credits that are in the proposals. The President's proposals also focus on investing in children, and we have a child care tax credit which we believe is desirable that is carefully targeted to low income recipients in making the existing provisions refundable we also believe to be desirable.

Our estimates of the revenue estimators, the Treasury Department indicate the net effect of these and other receipts proposals included in the President's proposals are relatively small. Receipts are estimated to increase modestly over the next several years.

We can come back to that, as I have said, in the question and answer.

Let me turn to the economic outlook. Chairman Rostenkowski addressed himself to that in his introductory remarks.

First of all let me say that I am cautiously optimistic about the economic outlook. We hear much that because the expansion is long it must run out of gas sometime soon. I believe that is a misreading of factual economic history and of the evidence. We have had expansions which have been short-lived, others that have been long-lived. There is no reason that this expansion cannot continue for some considerable length of time.

There is no statistical relationship between the probability of recession and the length of an expansion. That is the subject has been carefully researched by innumerable economists, and no such relationship exists.

Indeed this expansion did not run out of gas, or die when it reached the length of the second longest expansion. It has continued for some length after. We are well over 6 years into this expansion.

Expansions tend to peter out or die or turn into recessions for three sets of reasons. The first would be a severe external shock to our economy, which is by its very nature usually unpredictable.

The most blatant and important recent example is the quadrupling of energy prices, of oil prices in the 1970's which led to a rather severe recession in the mid-1970's.

An expansion can die also because severe imbalances get created in the course of the expansion. For example, in huge run-up inventories there is no such evidence in the current time that that is occurring in our economy today.

And they can die because of bad economic policies, whether those policies were designed to achieve that result or because of incomplete information lags in the effect in the implementation of the policy, or most importantly lags in the impact of the policy on the economy once implemented, and the difficulty of reversing those policies—all of those things can cause an expansion to slow and turn into a recession.

But I am cautiously optimistic that we will avoid all three. The recovery will continue the expansion, the expansion will continue for some time to come.

The economy has made considerable improvements. We have adjusted to some of our imbalances. Domestic demand growth is slowed and our external balance improved substantially in 1988.

There are those who are concerned that the real risk to our economy is not recession, but inflation. While we are at a point in the expansion we are at risk for an acceleration of inflation is certainly greater than it was in the early stages of an expansion, and this risk is real. We must number one be sure that we do not allow inflation to ratchet up as it did in the 1970's. That is bad in and of itself, but almost certainly the cost of getting the inflation Genie back into the bottle could be quite severe.

We do not want to go through an episode like we did in 1981 and 1982 again. High and variable invariable inflation as we experienced in the 1970's does great harm to the economy and must be prevented.

Relatively steady inflation in the 4.5 percent range or so also has costs, although obviously less than much higher and fluctuating inflation. So we are all agreed that the long term goal must be price stability, the reduction of inflation to levels that are consistent with inflation not being an important criterion in economic decision making.

The recent economic data on inflation, however, have been mixed. If we look at the fourth quarter of 1988—the first quarter of fiscal year 1989, inflation as measured by the most broadest and best measure, the fixed weight GNP price index actually fell from 5.3 to 4.2 percent. It declined a hair as measured by the Consumer Price Index.

Producer and consumer prices did accelerate. Sharply increased in January. Some of that, however, was due to what will prove to be transitory effects of increases in oil prices and tobacco prices. They may well be reflected for another month or 2 in the price data, but they should not affect the Consumer Price Index in the spring, summer, and fall.

The employment cost index has been rising more rapidly in the last several quarters, and that is one of the reasons the Federal Reserve has begun a long effort to prevent inflation from accelerating on the wage cost side.

In the long run, inflation is largely a monetary phenomenon, and I and the administration support the Federal Reserve's desire to bring inflation down.

Let me turn, Mr. Chairman, to the issues of the economic projections you discussed in your opening testimony and on which Mr. Archer also touched on.

Let me first say that the Bush administration has not made a new forecast, so let me explain why and how we are operating and how we will exchange information with this committee and others throughout the process.

We will produce a full new forecast no later than the mid-session budget review which will be released to the public no later than July 15 for which information will be exchanged throughout.

In the interim the administration has indeed modified the Reagan administration forecast to reflect changes in the economy that have occurred since that budget was prepared in November of 1988.

The inflation and unemployment projections for the first quarter fiscal 1989 were fairly accurate, but adjustments required, as you indicated, in the interest rate and GNP levels. In recent months interest rates certainly have risen, especially short term interest rates, and we substituted the actual rates for the Reagan projections of the rates up to the time of the budget forecast, and then rather than assuming a precipitous decline to much lower levels, we have a gradual decline meeting up with the Reagan forecast in the second quarter of fiscal year 1990.

It is also the case that the first quarter fiscal year 1989 had a higher GNP than had been predicted, and to be realistic and to be conservative we only counted one-half of that increase in our estimates of the budget that we presented on February 9, sir.

And these have conflicting and offsetting effects on receipts and outlays, and they have a very modest impact on the overall budget.

Let me just say three things about the budget forecast, sir. First of all, there is an important difference between the administration's projections, the Reagan administration's projections and the ones that we have been working with and presented you with, sir. Then there are the private forecasts. The administration's projections are based on the assumption that the economic policies, including the very substantial deficit reduction proposed by the President in the budget proposals will be enacted promptly. Obviously private forecasters consider there to be some nontrivial likelihood that that will not in fact eventuate promptly.

The difference is critical, and I stand before you as a professional economist who will say that most economists, including many this committee has heard and with whom you have worked over the years and recently, believe that if a major deficit agreement is reached, interest rates will fall substantially. Chairman Greenspan has stated a similar view.

It is my own personal view that if a credible deficit reduction program is not enacted it is very unlikely that interest rates will fall substantially, and in that case these estimates or these projections will prove not to pan out.

That is important to understand that these are not forecasts of what will happen no matter what happens on the budget front.

They are projections conditional on the deficit reduction being similar to that proposed by the President be enacted and enacted promptly.

It is instructive to examine a recent history, and I will refer all of the members to the table in the back of my testimony, to refer to a recent history of interest rates. Because interest rates, until the last few days, had been rising some, people were skeptical that interest rates will ever fall again.

It is instructive to compare what happened in the 1984 period when we are at—still in the second year of recovery with much room for the economy still to grow, inflation had come down to approximately current levels, and then we passed Gramm-Rudman-Hollings in 1985.

There were many reasons interest rates fell in this period. It is my own personal opinion and that of many others that a major contributor to the fall of short and long term interest rates was the passage of the Gramm-Rudman-Hollings Balanced Budget Act, which gave some teeth and some discipline to the budget process and the budget notion that we would get back on a credible deficit reduction path.

Now we all know we have had a Reaffirmation Act since then, and as you, Mr. Chairman, referred to in your opening remarks that there were certainly examples in the budget process of some smoke and mirrors being used in the 1980's that were not real deficit reductions. Some one time savings and shifting of funds from one to year to another and so on.

We need a credible deficit reduction program that does not rely on such things, and I could not agree with you more.

But if we go back to the interest rate scenario, we see that from prior to Gramm-Rudman-Hollings to shortly thereafter long term interest rates fell from double digit levels to under 8 percent by 1986, the year after Gramm-Rudman-Hollings, short term rates from levels above current rates to rates under 6 percent in 1986 and 1987.

So in the short term forecast, the ones that will govern the fiscal year 1990 budget, and whether we reach the Gramm-Rudman-Hollings levels in fiscal year 1990, certainly it is in the ballpark to argue and to believe that a credible deficit reduction package will enable interest rates to fall substantially. I believe that is the best weapon at our disposal and we ought to use it.

Second there is a lot of confusion about the forecast for 1989, let me say that adjusted for the complicated and confusing effect of the drought we had in 1988, the actual forecast is for drought-adjusted real GNP to grow slightly less robustly in 1989 than in 1988.

Third, I think too much has been made of the differences in the long range forecast made by the Reagan administration and what the Federal Reserve has indicated the 2.5 to 3 percent range it considers the long term sustainable growth of the economy.

The long term forecast in the Reagan budget was an average of about 3.2 percent real growth. Arguing about a quarter, or a third of a percentage point is well worth doing in understanding the differences, but we believe that monetary policy consistent with the Federal Reserves's desire to prevent inflation from accelerating consistent with their own monetary growth targets is consistent with our growth forecast.

Let me also state that for those of you who think 3.2 percent is way off the mark while many of other things have changed, the U.S. economy for the last 40 years has average 3.3 percent growth in a period that has included eight recessions.

Now, demography has changed, productivity growth is not as great today as it was in the 1950's and 1960's but certainly much greater than in the 1970's, and one could reasonably argue about that number, but we believe it is unreasonable to argue it out of the ballpark given it a slightly below historic growth rate.

Let me reassure you that we will produce a first full set of economic projections and assumptions no later than the midsession, and we will be an active exchange of information with the Congress. We will not spring a surprise at the midsession review as negotiations—if negotiations are entered into on the budget we will be exchanging information not only on budget priorities and spending proposals and the receipts proposals of the administration and any that your colleagues may wish to bring to the table, but we will also be exchanging information on how we perceive the economy's performance as this progresses, and how we see the likely future performance of the economy.

So there is no desire to spring a surprise in any way at midsession.

Let me also say that the professionalization that I bring to my job and that my colleagues in Treasury and the Office of Management and Budget bring there leave me to state unequivocally that those midterm projections will encompass the most careful thorough analysis of likely future transitive, real income growth, that is productivity and labor growth, inflation, unemployment insurance rates that I and my colleagues at the Council of Economic Advisers working closely with the Treasury and the Office of Management and Budget, through what is called the Troika, can possibly develop.

Let me indicate one last thing before concluding, Mr. Chairman. We were confronted with a choice when we came into office with doing a whole new forecast or with making the amendments I have suggested we have made, indeed, to the Reagan forecast—if we had done a new forecast—say we had indicated inflation or interest rates and so on would have been somewhat different from the Reagan administration, we would have had to go out and reestimate the costs of over 1,000 Government programs. Those would have had to be sent out to the agencies which were in the midst of their transitions, and we would have delayed the presentation of the President's budget proposals for many weeks, perhaps to the eve of the budget resolution deadlines of the respective Chambers of the Congress.

It is my personal belief, and it is one that the President shared that that would have been unreasonable that we needed to get those proposals out quickly, and so I wanted to let you know that that was one of the primary criteria that is used in deciding to go ahead quickly and not to hold things up. We thought that would have been unreasonable from our point of view, the Nation's point of view, and unreasonable from the standpoint of the view of the budgeting process.

Finally let me say that when we look at reducing the budget from this year's projection from about $170 billion to reaching the Gramm-Rudman-Hollings target of $100 billion in fiscal year 1990, the two biggest components of that would be the natural growth of revenues—the Congressional Budget Office estimates revenues would be even higher than we have estimated, and whatever spending restraint and spending reductions from programs that occur.

We certainly could change the economic assumptions, and undoubtedly in midsession there would be a reevaluation and before that a reevaluation which may lead to some changes in interest rate or growth or other parts of the forecast. But even if we adopt the forecast of others, if we reduced real growth a little bit, or raised interest rates and inflation and that is the major reason interest rates would be forecast to be a little higher, that the likely impact of that on the bottom line of the budget is rather modest, at least in the early stages in the first couple of years, and relatively small compared with the $70 billion reduction that is being contemplated to reach the $100 billion Gramm-Rudman-Hollings target from the estimated $170 billion in fiscal year 1989.

In summary, sir, I believe the President's economic plan is not only sound in the short term but by seeing the refocus on longer term investment, for which the best thing we could do is reduce the budget deficit and interest rates, it provides a framework to enhance long term growth. Working with the Congress we can together encourage further economic growth, Mr. Chairman. We have an opportunity by reducing Government borrowing to increase national saving and investment productivity which is the key to continued increases in our standard of living.

Mr. Chairman, I would now be happy to answer any question you or other members of the committee may ask.

[The statement of Mr. Boskin follows:]

FOR RELEASE UPON DELIVERY: 10:00 A.M. E.S.T.

INTRODUCTORY STATEMENT: THE PRESIDENT'S ECONOMIC POLICIES, BUDGET PROPOSALS AND ECONOMIC OUTLOOK

STATEMENT BY MICHAEL J. BOSKIN
CHAIRMAN, COUNCIL OF ECONOMIC ADVISERS
BEFORE THE HOUSE WAYS AND MEANS COMMITTEE
WASHINGTON, D.C.

Wednesday, March 8, 1989

Chairman Rostenkowski, Representative Archer, and other distinguished members of the Committee, it is a pleasure to appear before you today to discuss President Bush's economic programs, the economic outlook, and their relationship to the budget. I have on numerous prior occasions, as a private citizen, testified before, and consulted with, the Ways and Means Committee. This is my first opportunity to do so in my new capacity as CEA Chairman.

Today I will briefly summarize the basic thrust of the President's economic policies, the economic outlook and some budget issues of interest to the Committee, and then I will be happy to answer any further questions. Since you have already heard from the Director of the Office of Management and Budget, Richard Darman, I will try to avoid unnecessary repetition, especially the details on the budget proposals. Further, since you will hear from Treasury Secretary Nicholas Brady tomorrow, I will also defer detailed presentation of Administration receipts proposals to him, as he is not only the Administration's chief economic spokesman, but the head of the agency with line responsibility for these issues.

Economic Policies. - The Administration's primary economic policy goal is to promote further economic growth. We seek to extend the current economic expansion while avoiding an acceleration of inflation. There are four basic components to the Administration's plan for achieving sustained noninflationary growth.

First, the Administration believes the number one priority must be to reduce the federal budget deficit substantially, steadily and predictably. We stand ready to enter negotiations with the Congress to achieve that end.

Second, the Administration believes the United States must lead the world to freer and fairer trade. A primary focal point will be through negotiations in the Uruguay round of the GATT. While we must not allow unfair trade practices to continue, we must also avoid the temptation to fall into a trade war. That is the surest way to throw our, and the world, economy into a recession.

Third, the Administration believes the U.S. economy must maintain its flexibility and dynamism and this will necessitate avoiding unnecessary regulation. This is a particular interest of both President Bush, who headed the task force on regulatory reform in the previous administration, and of Vice President Quayle, who is heading the Council on Competitiveness.

Fourth, the Administration supports a monetary policy which predictably controls inflation. In recent weeks much has been made of alleged differences between the Administration and the FED. I can assure you this made a mountain out of less than a molehill. The Administration and the FED share the goal of containing and eventually reducing inflation. We both also seek sustained economic growth.

Deficit Reduction.-Reducing the Federal budget deficit is the surest way to raise the current low rate of saving in the United States, reduce real interest rates and thereby expand business and housing investment, and promote growth. Increased investment raises productivity, improves U.S. competitiveness, and raises standards of living.

Household saving has been particularly low in recent years. The reasons for this decline are many, and partitioning blame among the potential causes is difficult. Without a confidently precise estimate of the causes of changes in personal saving it is difficult to develop policies to change personal saving behavior. And we must be especially careful not to adopt policies which are designed to raise private saving but do so at the expense of public borrowing. That just transfers still more of the problem of the low national saving rate from the private to the public sector.

Reducing the Federal deficit therefore is the most effective way to raise the national saving rate. Indeed, the Gramm-Rudman-Hollings law targets a balanced budget by FY 93. It is economically desirable not only to meet these targets, but to run a unified budget surplus on average thereafter. The deficit must be reduced in a way that does not reduce private saving, for that would just shuffle the problem of low national saving from the public sector to the private sector. We also should be wary of reducing productive government investment. Reducing government dissaving should come through slowing the growth of government consumption.

While an inflow of foreign investment funds has prevented the U.S. investment rate from falling despite the large budget deficits, the share of investment in GNP in the United States is lower than that of most of our major competitors.

High Federal deficits and borrowing raise interest rates. Interest payments now account for 3 percent of GNP and 14 percent of the Federal budget.

Large federal deficits also contribute to our trade deficit. High rates of government spending and private consumption helped to raise domestic demand above domestic production, with imports making up the difference.

In addition to these economic factors, there is a moral; or ethical dimension as well: we should not be leaving to future generations a larger public debt burden (relative to their income) unless we also leave them more public and/or private assets.

Improving Incentives and Equity.- The Tax Reform Act of 1986 was an historic achievement, in no small part due to your efforts Mr. Chairman, and the nation is the beneficiary of the important reductions in marginal tax rates that improved many economic incentives. In addition, the Act embodied important improvements in equity. However, no single act can achieve all goals and there are areas where we feel that there are further improvements that can enhance incentives and equity.

The President's policies include a number of initiatives to raise investment and productivity. Among these are proposals to encourage long-term investment in both human capital and tangible capital and others to encourage and expand our research efforts.

Prominent among the policies to encourage long-term investment is the President's proposal to restore the capital gains tax differential. During this expansion a large share of the job growth has been in small and medium sized firms. Proprietors' income which had been declining as a share of personal income throughout the post-war period as a share of income, has begun to rise during this expansion.

This Administration would like to improve investment incentives by lowering--in a carefully designed manner--the tax rate on long-term investments. High tax rates on capital gains reduce the returns to saving, investment, risk taking, and entrepreneurial effort. They also lock in inefficient investments--preventing capital from moving to higher productivity uses--thereby significantly reducing realizations and reducing tax revenue. (If held until death under current law, capital gains can entirely escape taxation).

A lower capital gains tax rate will reduce the taxes paid on purely inflationary gains and raise investment incentives by increasing real after tax rates of return. A lower capital gains rate will help to offset the current tax bias against corporate equity. A lower capital gains tax will also improve the U.S. competitive position since most of our major trading partners tax capital gains lightly, if at all.

In addition to the capital gains tax proposal to encourage long-term investment the President has proposed a number of initiatives to improve the United States position in science and technology and raise U.S. productivity. These include some spending initiatives as well as making the R&E tax credit permanent. A permanent tax credit for research and experimentation will help to develop new and improved technologies. To improve incentives for U.S. based technological innovation, changes have also been proposed for the allocation of R&E expenses. These changes will result in some lost revenue, however, we believe the gains in improved productivity, standards of living, and competitiveness will outweigh the foregone revenues.

A variety of energy tax credits have been proposed to improve incentives for increasing domestic energy supplies and reducing our dependence on foreign oil and our vulnerability to possible supply disruptions.

The President's proposals also focus on equity and opportunity. To better provide for the child care needs of low income families, a new targeted child care tax credit has been proposed. This plan will maximize choice and avoid the administrative and other inefficiencies of publicly provided services.

The net effect of these and other receipts proposals included in the President's budget are small. Receipts are estimated to rise $0.7 billion in 1989, $4.2 billion in 1990, $4.0 billion in 1991, $3.2 billion in 1992, and $1.6 billion in 1993.

Economic Outlook. Underlying these spending and receipts estimates are the economic outlook and the projected path of inflation, interest rates, unemployment and real GNP.

I am cautiously optimistic about the economic outlook. I do not believe that there is sufficient regularity to expansions and contractions to talk about a business cycle that requires expansions to die of old age. Some expansions have been very short-lived; others, very long-lived. Most expansions have ended either because of severe external shocks, such as the quadrupling of oil prices, or because of policy errors. I believe that with continued adjustments in our economy, sensible economic policy, and no severe external shocks, the current U. S. expansion can continue for some time. Indeed, the expansion does not currently exhibit the problems usually associated with impending contractions, such as excessive inventory accumulation.

The U.S. economy is beginning to make adjustments to some of its imbalances. Domestic demand growth has slowed. This is important because for many years domestic demand grew much faster than domestic production, a large increase in net imports making up the difference. Over the four quarters of 1988 real GNP grew at a 2.7 percent annual rate, while gross domestic purchases grew at a slower 2.0 percent annual rate. As a result the trade deficit as measured by real net exports in goods and services declined by $25.3 billion. Equally important was the increase in productive investment, with real nonresidential fixed investment growing at a solid 5.2 percent annual rate, albeit somewhat more slowly than in 1987. Increases in investment are important because of their effect in raising productivity and real GNP. We must strive to support income growth, not just contain spending.

In addition to the improvement in foreign demand and other factors that have helped to produce these adjustments, further improvement in the trade and current account deficits will require a reduction in the Federal budget deficit (and would be aided by a further increase in the very low personal saving rate). This reduction in the Federal deficit should take the form of slower growth in government consumption. Reductions in productive government investment or actions which lower private saving will reduce rather than raise our future standards of living.

There are those who are concerned that the real risk we confront is not recession, but inflation. We are now at a point in the expansion where an acceleration of inflation is a greater risk than it was earlier. This risk is real and we certainly do not want inflation to ratchet up as it did in the past, eventually reaching double-digit levels we saw in the late 1970s. Inflation of that magnitude is not only bad per se, but it is very painful to reduce. We do not want to go through an episode such as the 1981-82 recession again.

High and variable inflation, such as we experienced in the 1970s does great harm to the economy and must be prevented. Relatively steady inflation in the 4-1/2 percent range also has costs, although far lower than the costs of the late 1970s inflation. Therefore we are all agreed that our long-term goal should be price stability.

However, the recent economic data on inflation have been mixed. In the fourth quarter of 1988, inflation by the broadest measure, the fixed weight GNP price index, fell from 5.3 to 4.2 percent. Inflation as measured by the Consumer Price Index was little changed, declining slightly from 4.5 to 4.4 percent. Producer and consumer prices did show a sharp increase in January, but that was partly due to increases in oil and tobacco prices. The effect of higher oil prices will probably continue to be reflected in the Consumer Price Index over the next couple of months. The employment cost index has been rising more rapidly in the last several quarters, and the Federal Reserve has been attempting to make certain inflation does not accelerate on the wage cost side. I will continue to monitor these data carefully. but I do not yet see a serious increase in the underlying inflation rate, partly because the FED has been moving for some months to forestall any such possibility. In the long-run, inflation is largely a monetary phenomenon, and I support the Federal Reserve's desire to bring inflation down.

Economic Projections. - As you know Mr. Chairman, the Bush Administration has not made a new forecast. We will produce a full forecast no later than the mid-session budget review, which is to be released to the public no later than July 15. In the interim, the Administration has modified the Reagan Administration forecast to reflect changes in the economy that have occurred since the forecast was prepared in November of 1988. The inflation and unemployment projections for the first quarter of the fiscal year 1989 were fairly accurate, but adjustments were required in the interest rate and GNP levels.

In recent months, interest rates, especially short-term interest rates, have risen and actual interest rates for the first four months of FY 1989 have been substituted for those forecast in November. Interest rates are assumed to come down gradually to the projected levels by the second quarter of FY'90. The result of this change in economic assumptions is to raise short term rates for FY'89 by 1.0 percentage point, from 6.7 to 7.7 percent. Long-term rates for FY'89 are raised by 0.3 percentage point, from 8.5 to 8.8 percent.

In the last quarter of 1988--the first quarter of FY 1989 --nominal GNP rose faster than projected. Because estimates of GNP are revised several times before they are final, the level of nominal GNP for the first quarter of FY 1989 was only raised by one-half the difference between the advance GNP estimate and the November projection.

Because higher nominal GNP raises receipts while higher interest rates raise expenditures, the net effect of these changes in economic assumptions on the projected deficit were rather small. The projected deficit for FY'89 was raised by $0.4 billion, and for FY'90 by $0.8 billion. The changes lower the projected deficits for subsequent years, by $0.4 billion in FY'91, $1.0 billion in FY'92, and $1.3 billion in FY'93. Except for these changes in the level of interest rates and nominal GNP, projections for the future have not been changed.

There has been much debate over the reasonableness of the Reagan forecast, which I would like to address briefly. First, I would like to point out that Administration projections differ from economic forecasts. They are projections based on the assumption that the President's budget will be promptly enacted. This difference is critical. For example, I, as well as most economists, believe that if a major budget deficit agreement is reached, interest rates will fall. Chairman Greenspan has stated a similar view.

It is instructive to examine the recent history of interest rates so that we do not forget that they can move down as well as up, and to note the potentially powerful beneficial effect of a serious credidible deficit reduction package. As the attached table shows, long-term interest rates fell substantially from double digit levels to under 8 percent in 1986, and short-term rates from levels above the current rate to under 6 percent in 1986 and 1987. Obviously, many factors affect interest rates. An important factor immediately preceding the sharp drop was the passage of the original Gramm-Rudman-Hollings balanced budget act. I believe this provides strong backing for the position that a credible deficit reduction package would lead to a substantial reduction in interest rates, and a reply to those who imply that there is an iron law that interest rates can only go up for the indefinite future.

If a credible deficit reduction plan is not adopted soon, it is far less likely that interest rates will fall, and the FED will have precious little elbow room in implementing a monetary policy designed to achieve steady growth and low inflation.

Second, there is much confusion over the forecast for 1989. Fourth-quarter over fourth-quarter growth in real GNP was projected at 3.5 percent. Most of this increase in real GNP growth over the 2.7 percent during 1988, is simply the rebound from the abnormally low levels of real GNP caused by the drought. (According to the chief meteorologist at the Department of Agriculture, another serious drought is unlikely this year.) Excluding the drought rebound, the forecast is for moderate 2.8 percent growth, slower than the drought adjusted pace of growth in 1988.

Third, I think too much has probably been made of the differences in the long-range forecasts made by the Reagan Administration and what the Federal Reserve considers sustainable growth. The long-term forecast of 3.2 percent real GNP growth is only slightly above the 2-1/2 to 3 percent range recently cited by Chairman Greenspan. Monetary growth consistent with the FED's long-term goal is also reasonably consistent with real GNP growth in the range of 3 percent or slightly higher.

While 3.2 percent average real growth is toward the optimistic end of the spectrum of forecasts, it is instructive to realize that real GNP growth has averaged 3.3 percent over the past 40 years, a period including eight recessions.

As stated above, we will produce a first full set of economic projections and assumptions no later than the mid-session review. Those projections will incorporate both the updated information on the actual performance of the economy between now and then and the most careful, thorough analysis of likely future trends of real growth (productivity and labor force), inflation, unemployment and interest rates that I and my colleagues at CEA, working closely with our colleagues at Treasury and OMB through what is called the Troika, can develop.

Also, let me indicate that to make a careful thorough new forecast or projection and to re-estimate the cost of over one thousand programs in all agencies of the government, as well as changes in receipts, would have taken many more weeks. To do so would have delayed presentation of the Administration's budget proposals perhaps to the eve of Congressional budget resolution deadlines. That would have been much more unreasonable than opting to adopt, for the time being, most of the Reagan Administration's projections.

Fourth, it is important to place the economic assumptions in perspective. The budget deficit will have to be reduced by about $70 billion, from roughly $170 billion in FY'89 to $100 billion in FY'90, to achieve the Gramm-Rudman-Holling target. The effect of changes in economic assumptions is small in comparison to the required changes in the rate of spending growth and the anticipated natural growth in revenues.

Conclusion.- In summary, I believe the President's economic plan is not only sound in the short-term, but by seeking to refocus on longer-term investment, it provides a framework for enhanced long-term growth. Working with the Congress we can together encourage further economic growth. We have an opportunity, by reducing government borrowing, to increase national saving, investment, and productivity, which is the key to continued increases in the U.S. standard of living.

Mr. Chairman, I would now be happy to answer any questions you or the members of the Committee may have.

ECONOMIC OUTLOOK

TRENDS IN INTEREST RATES IN RECENT YEARS

Year	3-Month T-Bills	10-Year Treasury Notes
1984	9.6	12.4
1985	7.5	10.6
1986	6.0	7.7
1987	5.8	8.4
Current (cob 3-6-89)	8.6	9.3

Chairman ROSTENKOWSKI. Thank you, Mr. Boskin.

Mr. Gibbons will inquire.

Mr. GIBBONS. Very interesting discussion there, sir, and as I listened to you I almost get hypnotized that everything is going to be great, but I have a feeling underneath my skin that things are not going to be so good.

I want to first talk about some practical problems that we face here in this committee. We are going to be asked to borrow a great deal of money, on or off budget, to lessen the impact of those depositors and savings and loans associations are not covered by FSLIC insurance.

I am not sure how much money that is. I do have a gut feeling about it though that we should not borrow that money, that we should raise it some other way because if we borrow it there is going to be a lot of interest to be paid over the future. I feel that this is a mistake that our generation, yours and mine made that we ought not to pass on as a borrow-principle this mess to our children and grandchildren.

Now how much money are we going to have to borrow? How much is it going to cost us over a 10-year period, and would it not be better to do it by some kind of revenue measure?

Mr. BOSKIN. Mr. Gibbons, let me say that I agree that we have inherited a fair number of problems from the past of which the S&L mess is one, and that we——

Mr. GIBBONS. That is our generation's mess.

Mr. BOSKIN. There are lots of reasons that this has occurred, and I would not seek to point blame there.

Mr. GIBBONS. It is our generation's mess, and it ought not be something we should pass on to our children.

Mr. BOSKIN. And we need to deal with it, and the administration has presented a proposal to move forward and to move forward expeditiously, and I know it is working its way into the Banking Committees and so on, and are holding hearings and are moving forward.

It is my own belief that the Treasury estimates over the 10 year period of the size of the problem being on the order of $126 billion approximately correct. We have heard a lot of other estimates, some smaller, some higher, but they are very difficult to compare because some look over longer periods and do not discount to the future, that there is a future sum, cumulative undiscounted, not adjusted for inflation value.

I believe that the two primary components, the $40 billion in resolving thrifts that have already been—that are already in the system even though all of the funds have not necessarily been expended, and the $50 billion recapitalization together with the other proposals made by Treasury and advanced by the administration should prove sufficient barring any major unforeseen events.

There are additional potential funds available above and beyond the time period of the RTC, and so I believe that we have that problem more or less in the general proper overall perspective.

The funds, while it varies from year to year, about half will come from taxpayers and about half from the private sector, industry sources, industry funds being put up as capital to buy zero coupon bonds to collateralize the $50 billion principal.

Mr. GIBBONS. That has all got to come out of the savings pot we have there.

Mr. BOSKIN. You are quite correct. The interest payments will be made on those things in the future, and there will be outlays made and there will be revenues required, receipts required to fund those outlays in the future through time. Those have been fully scored into the budget process. We have kept careful track of all of the cash flows.

I know Secretary Brady intends to go into great detail tomorrow, sir, but the key point is if we had compared your proposal, which I take it is to have a very large direct—say tax increase or something to pay for it now, or whatever, or compare that to the Treasury plan—it is my own personal belief that there are many advantages to the Treasury plan. It gets a substantial amount of private capital into the pot, and also importantly it has a major reform component.

I think it is important that we not establish the principle that taxpayer funds be first in line, but back to a system——

Mr. GIBBONS. I agree with you on all of that. If it is going to cost $50 billion, if there are $50 billion of deposits out there, and I do not know why any fool would keep their money in that institution, but that is beyond me.

Why do we go ahead and borrow $50 billion? In 8 years we will owe $100 billion. In 12 years we will owe $200 billion, just the compounding of the interest on our debt.

All of this money has to be borrowed, sir. You are making money out of—we can make those people put up the capital, but the way you have explained this thing it is a bunch of gobbledygook, and it looks to me as if it is another attempt to pass off on the poor people who cannot vote, who have not been born yet, the mess that you and I have created.

Now that is what it looks like to me.

I am not going to go along with anymore passing along to future generations the mistakes that we have made. That is my position, and can you read my lips?

Mr. BOSKIN. Yes sir, I can. I certainly agree that we should not be passing this on to future generations, and we have tried to move expeditiously and quickly to deal with the problem in a way that guarantees that all those who have deposits in depository institutions with Federal guarantees will have their funds safe, and we have tried to move quickly to put together a plan that would be——

Mr. GIBBONS. But no more borrowing. No more borrowing.

Mr. BOSKIN. Well sir, I respect your view.

Chairman ROSTENKOWSKI. Mr. Archer will inquire.

Mr. ARCHER. Thank you, Mr. Chairman.

Dr. Boskin, would you agree that tax policy can affect the savings rate in this country?

Mr. BOSKIN. Yes, I would, sir.

Mr. ARCHER. Do you believe that tax incentives could amplify the total savings of the United States?

Mr. BOSKIN. Yes. I believe carefully chosen tax incentives could do that.

Mr. ARCHER. Do you further agree that increased taxation of savings or income from savings is a negative on aggregate private savings?

Mr. BOSKIN. I certainly do. I think it would be a major mistake.

Mr. ARCHER. I do not know if you happen to have read the "Wall Street Journal" editorial from yesterday—I am sorry, from March the 1st entitled "The Elderly's Tax Trap."

Mr. BOSKIN. Is this referring to the Medicare and so on that can get people into a situation——

Mr. ARCHER. This refers to the inner working of the taxation of Social Security benefits, the loss of earnings as a result of the retirement test, or the earnings limitation test under Social Security, of which you are well aware because you have done a lot of study of that.

Mr. BOSKIN. Sure.

Mr. ARCHER. Most recently we have added a special surtax under the income Tax Code to pay for catastrophic illness. It is primarily a combination of those three items that impacts so negatively on the elderly. The article cites that: "Some elderly who are working or want to work will face marginal tax rates as high as 102 percent. For the elderly self-employed marginal tax rates can now go as high as 122 percent if they have any investment income."

It cites the anecdote of an elderly widow earning twice the minimum wage who would see her total income reduced by $27 if she got a $1,500 raise, and a married man earning only $8,880 that could suffer an $18 cut in his income if he got $1,000 a year raise. Of course, the frosting on the cake is the new surtax in the income Tax Code to fund catastrophic illness.

You are rightfully concerned about savings in this country. I share that concern. What kind of signal are we sending to younger Americans. If they save so that they have taxable income to take care of themselves after they retire—which I think we are supposed to be encouraging younger workers to do so they will not be wards of the Government—that they are faced with the potential of a marginal tax rate of 48 percent once they have retired and are over age 65?

Do we not send a terrible signal to the American public that you are a fool if you save? Get your money up front in cash, do not negotiate a union pension plan, do not work for a better company pension plan, do not have an IRA, do not have a Keogh, do not put your own money aside in savings because once you get to be 65, the Government is going to take more and more and more away from it, and away from you through the specialized punitive tax rates, only because you are 65.

Now, I just wonder what your opinion is of this situation and whether you would support a change in the funding mechanism for catastrophic illness coverage?

Mr. BOSKIN. Well, I think that catastrophic illness coverage was a desirable program. And I realize that the funding mechanism was part of that compromise. I would—I would hope that we could figure out a way to get those marginal tax rates down without undoing the basic framework that catastrophic was passed in.

We have had that situation in the past, for example, with the poverty population, and we figured out various ways to get them out of this trap of having these very high marginal tax rates.

I do agree that as people approach retirement they have to start thinking about what is going to happen when they take their funds out of a pension program, start receiving Social Security and the like, and if they are going to be heavily taxed then, there are very strong incentives for them to either consume now or to shift their assets to some other form or to some other people, or something of that sort so that they reduce these potentially punitive tax rates.

Mr. ARCHER. Well, do you not think it would be wise for this committee to consider other forms and other methods of funding catastrophic illness rather than this highly punitive extra tax rate on those 65 years old and older?

Mr. BOSKIN. Well, I certainly believe that it would be desirable to try to figure out ways to deal with the problem of tax—marginal tax rates that may, far range, even exceed 100 percent. I think that is potential tremendously damaging to the work incentives and others.

But I would not go as far as to say sort of reconsider the entire framework.

Mr. ARCHER. No, I said the funding mechanism.

Mr. BOSKIN. Well, that part of the funding mechanism that gets into this kind of a notch problem I believe is serious problem and ought to be addressed.

Mr. ARCHER. All right.

Just one last question. It relates to your comment that you are concerned about capital gains tax on inflationary gains. There are a number of us who believe that we should seriously consider indexing the cost basis of capital gains. That has not been a part of the President's proposal. Do you have a view on that?

Mr. BOSKIN. I certainly do, Mr. Archer.

I believe that the President's proposal is a rough approximation and that it seems hardly perfect. I do believe that it is inequitable to tax purely inflationary gains. But I also believe in those countries which have tried to move to indexing that there have been substantial administrative costs and substantial complexities, particularly when they got into situations where inflation rates were other than very, very low.

So I think that the weight of that suggests to me that perhaps a general approach to it, even though it would not work item by item or person by person, such as a differential may get you some substantial fraction of what you need to do without the complexity. But I certainly share your concern about the unfairness and the incentive effects of taxing purely inflationary gains.

Mr. ARCHER. Thank you very much.

Mr. BOSKIN. You are welcome.

Chairman ROSTENKOWSKI. Mr. Pickle.

Mr. PICKLE. Thank you, Mr. Chairman.

I want to make an observation first in view of Mr. Archer's question about the catastrophic illness law. The suggestion is that we change the funding mechanism. Now, I would just ask the question in what way would you change the mechanism? How are you going to do it differently than we did?

The President said he would have vetoed that bill, and the only option we had was to put it on the premium. If you are going to talk about other ways to raise revenue, that means you are simply going to have to raise the tax some way or another or change the funding mechanism.

And we do not know enough about its impact now. The only thing we know about the administration is he recommended we fund this way.

I just make the observation it is fine to say the premiums are burdensome, but it is either that or you do not have a program, period.

Mr. BOSKIN. I think the program, sir, was—is desirable. In my remarks I was referring only to whether there could be some minor changes to get out of this extraordinary circumstance for some people who get temporarily into a situation where they face higher than 100 percent tax.

Mr. PICKLE. Well——

Mr. BOSKIN. I do not favor reopening the funding mechanism per se.

Mr. PICKLE. No. And the urge of everybody is that, oh, this is a surcharge, a surtax, and you can understand their feelings. But I just think we have got to be careful. If we are going to change this thing and repeal the funding mechanism, somebody suggested that we ought to come up with a plan. But otherwise, we better see how it works out in the next year or two.

Mr. BOSKIN. I agree with that.

Mr. PICKLE. Mr. Boskin, I am glad to have you here before the committee again.

Mr. BOSKIN. Thank you, sir.

Mr. PICKLE. I want to proceed further. There is one item that bothers me a great deal, and that is the capital gains. Now, the administration has said that over a period of 6 years, we would probably gain as much as $9 or $10 billion in new revenue from its proposal. The Joint Tax Committee has said we would lose $24 billion over that time.

Potentially that is a difference of some $35 billion. Now, who is right? How can you have that big a difference between smart people?

Now, you can comment on that. Can you tell me how you think—or is that just an estimate, the $9 billion will be raised?

Mr. BOSKIN. No, no, no. These are very careful, professional people on both the Joint Tax Committee and in the revenue estimating office in the Treasury.

Mr. PICKLE. Well, then are we to assume that it will be normal that very careful, educated, informed people would estimate that much of a difference?

Mr. BOSKIN. I think that there are two particular differences here, sir, relative to normal revenue estimating. One is the capital gains has a variety of steps that one has to go through in order to get an estimate of what the likely effect is. If you say lower the rate to 15 percent, to give a simple URISA characterization to the President's proposal——

Mr. PICKLE. Well, I have always supported lowering the capital gains tax rate. I have always felt that it would probably make us some money. But I do not remember any administration, including the last administration, that ever thought that or who appeared before this committee and did not say that that would be a bad thing, that we would lose revenue, big revenue.

The Reagan administration has just gone out, having agreed on the 28 percent, and now the Bush administration wants to lower it. I am just simply saying to you that if you want the members of the committee who believe in preferential treatment for capital gains, you are going to have to get some more figures to get these things more in harmony. When you have that wide a difference, then I think the average member who—even those who favor lowering the capital gains tax rate—say you have got to be more realistic than that. And you may not go from 28 to 15 percent, there may be some compromise, but there will not be any accepting of 15 percent, I do not believe, unless you can see that the cost figures are more in line.

So I will just alert you that you may have friends here that want to help, but we have got to have some more facts before we can plunge forward into this.

Mr. BOSKIN. I appreciate that, sir. We are trying to work with the revenue estimators in both the administration and in the Congress to deal with that. There are a lot of studies that have been done about the responsiveness of realizations to changes in rates, and there are a whole range of those studies that do not come to any uniform conclusion. The Treasury used a middle-range estimate of that. They apparently differ with the Joint Tax Committee on what is likely to happen in the long run.

Let me just make one point though. If we take all of the proposed receipts legislation of the administration, even if we substituted the Joint Committee on Taxation's ~~s~~ capital gains forecast for the administration's forecast over the period 1989 to 1993 the sum—the aggregate effect of all the receipts proposals would still be to decrease the budget deficit a little bit, to make a little bit of revenue, obviously much less with the Joint Committee's estimate than with the Treasury's estimate.

Mr. PICKLE. All right.

Now, Dr. Boskin, when we passed the tax bill in 1986, I made the observation that I did not know myself, using my country measurements, that the 28 percent rate would be enough to run this Government. I was concerned that it would be too low. Can you make a statement now about whether the 28 percent will bring in enough revenue to actually run the Federal Government?

Mr. BOSKIN. It is my belief that the reforms that were enacted in 1986, including the lower tax—lower marginal tax rates in the personal income tax, the corporate tax, plus the broadening of the base and the elimination of a lot of sheltering activity and so on, will bring in and continue to bring in substantial revenue.

We estimate over $80 billion more next year. The CBO estimates even higher revenue than we do. Whether it will be sufficient to run the Government depends upon getting a credible slower spending program in place than some people are projecting or predicting. It would take a very long time to grow our way out of the deficit purely by relying on revenue. We have to get spending on a slower growth path.

Mr. PICKLE. Well, we have had now a full year to, through all of 1988, to determine—to get a good estimate. And I am just raising the question again. Do we know now, do our economists, does your Department, does the administration know now whether 28 percent will be enough? We have closed a lot of loopholes, and we may be fairly close, but I think the jury may still be out. We may not know enough based on advance payments, or withholding, to have a good idea.

And I think that is a major question we have got to ask ourselves. If we had a 33 percent rate now, we would not be worried about this, would we?

Mr. BOSKIN. Well, there would certainly be a different mix of revenues and spending. That is for sure.

Mr. PICKLE. That is all.

And I thank you.

Chairman ROSTENKOWSKI. Mr. Downey.

Mr. DOWNEY. Thank you, Mr. Chairman.

Mr. Boskin, it is a pleasure to have you here in your official capacity before the committee. And I want to say that I do not know if there are any members, Democrat or Republican, that disagree with the broad goals, especially promoting economic growth, that the administration espouses that are contained in your statement.

I have one quick question on interest rates that I want to hold if I have time to ask, and I want to ask you some more philosophical questions. I realize that they may not necessarily all fall into your general jurisdiction of Chairman of the Economic Advisers.

But I want to ask your opinion about whether or not we should continue to tolerate, and whether or not you believe there might be some deleterious effect to the type of growth that we have had over the last few years.

I am referring specifically to what the Census Bureau has told us about a growing disparity in who is rich and who is poor in this country. They point out the fact that the top 5 percent of the income earners of this country over the last 6 years have done remarkably well at the expense of the bottom 20 percent with the middle 40 percent growing not at all, and the top 20 percent somewhat more. But the concentration of wealth in the top 5 percent seems to be a nice thing to have, but it seems also to be coming at the expense of others.

And the first question is does that cause you some concern? And, B, can we continue to grow with these income disparities continuing, in your opinion?

Mr. BOSKIN. Mr. Downey, let me start, sir, by saying that there certainly is some substantial income disparity. We do not have an exactly equal income distribution. If we look at the share of income received by those in the bottom quintile, it is substantially less than those in the middle quintile, let alone in the top quintile. The plight of those at the bottom has long been a concern of mine, both of the elderly and of people of any age. So I share your concern.

If one goes, which I have done, year by year to the census data—not just to decennial censuses—one would find that if one divides the population into income quintiles, each of the five groups has had real income gains since 1981. It is true that the real income gains of the top 20 percent have been proportionately a little larger than those as you go down. It is also true that if you go back to the 1970's, the period of mid- to late 1970's, that all groups had real income declines, the worst being in the low-income group.

So I share your concern, but I do not believe that it would be entirely accurate to say that the gains of the people at the top or of the general population have come at the expense of the bottom. Let me give you a few statistics that I think are relevant to add to your pool of information, in addition to the ones you cited, sir.

If one looks at employment growth in this expansion, women, Hispanics and blacks have had far greater proportional employment growth than white males. If one looks at real median income, the family exactly in the middle has been rising in this expansion, and it is now higher than at any other time.

I could go through a variety of other such statistics, but I think personal income has risen well over 20 percent in this expansion after adjusting for inflation. A small part of that, much more than some of the rhetoric would suggest, is due to second earners in families. The female labor force participation rate increased about 7 percent, about one-third of the total increase in personal income.

So it is my own belief that the best first step for almost all the population is a robust growing economy providing employment. There is a residual set of people or group of the population that is unlikely to benefit from that. It is small; it is not a large group of the population, but it is one we should be deeply concerned with. That is why we have means tested entitlement programs, and it is why I hope we make sure we continue to have that social safety net.

But I would prefer to think of the overwhelming bulk of the population having a common stake in having the pie growing rather than in fighting over dividing it up.

Mr. Downey. No, I agree. I want to specifically refer to an effort that Congressman George Miller, Senator Gore and I are making to dramatically expand the earned income tax credit, and to make refundable the dependent care credit.

Let me ask you, as a matter of philosophy, can we state a goal that people who work full-time should not be poor? I mean, is that something you could agree with?

Mr. Boskin. Well, as a general goal, it certainly would be desirable. How to achieve it might be subject to some differences of interpretation in an economic analysis.

Let me just applaud you for pushing the earned income tax credit. I think that philosophically and analytically it is an extremely important device. It has been a major improvement. And incrementally, as we move forward to deal with trying to get income into the hands of low-income people, it is targeted much more on the poor than some of the broader shotgun kind of approaches that people have suggested.

Mr. Downey. One of the reasons we embarked on this is because of the growing incidence, according to census data, of people who work full-time and who are poor. Clearly, one way to deal with that—and it is not a precise way to deal with it—is to increase the minimum wage. That is something I favor. But I also believe very deeply—and I would appreciate it if your office could analyze the legislation for us and let us know what you think of it—that more needs to be done for people who are not the recipients of Federal benefits for the most part, but who are working at low level wages and who, for the most part, are not achieving a poverty standard of living.

Mr. BOSKIN. It would be our privilege, sir, to assist you in that. Let me also say, you mentioned the minimum wage. We have an administration proposal that was presented by Secretary Dole.

Mr. DOWNEY. Yes.

Mr. BOSKIN. Let me also, however, make one remark, which is: If we take the number of full-time workers and then we look at the 3.9 million people working at the minimum wage, a very minute fraction of those people are full-time workers. So it is not the case that the minimum wage is likely to impact a large fraction of those people who are in the poverty situation.

Mr. DOWNEY. No, that is right, and many of them who are on the minimum wage are not poor.

Mr. BOSKIN. That is right.

[The following was subsequently received:]

Reducing the rate of poverty is a goal that is supported by both the Administration and Congress. The Administration's proposals for a child tax credit for families with children under the age of four is a step in this direction. This program, if enacted by the Congress, would supplement the existing earned income tax credit and will encourage labor force participation of low-income workers with children. It is estimated that about 2.5 million working families with children under the age of four will initially be eligible for the credit. The child tax credit, like the earned income tax credit, acts as a subsidy to encourge work and supplements the income of the working poor as it is added in advance to their paychecks. The Administration has also proposed that the existing dependent and child care tax credit be made refundable to provide further subsidy to work credit be made refundable to provide further subsidy to work and offer all parents a choice between the existing child care tax credit, and the new tax credit.

Further extension of the earned income tax credit must be examined within the context of existing policies designed to assist the working poor such as the minimum wage. Some economists prefer wage rate subsidies, similar to the earned income credit, as a substitute for the minimum wage. The President's proposals are a step in the direction of aiding the working poor with children. The way new policies will fit in with programs that currently provide benefits to those who are not working must also be examined. Ideally, programs to help the poor should help them enter the labor force and become self-sufficient.

Policies to meet the goal of eliminating poverty among those who work full-time must also be carefully examined to determine their budgetary implications. The effects of such programs work incentives and on requirements for additional revenue to finance earned income tax credits must be considered. In view of the budgetary restraint that will be necessary to meet the Gramm-Rudman-Hollings budget deficit targets in the coming years we must be careful not to embark on expensive new programs without careful study.

The Council will undoubtedly be considering these issues in the future and I will keep you informed as to our progress with this analysis.

Chairman ROSTENKOWSKI. Mr. Crane will inquire.

Mr. CRANE. Thank you, Mr. Chairman.

Welcome, Dr. Boskin.

Mr. BOSKIN. Good to see you.

Mr. CRANE. Back at the end of last year, I conceived a bill that I dropped at the beginning of this session dealing with the FSLIC bailout, and what it called for was the issuance of 10-year bonds in $10,000 denominations, paying 2 percent interest in gold. The gold would come out of our reserves at Fort Knox, and my understanding is there is over $60 billion there alone before you get to what we have in New York and London and Montreal.

I met with some international bankers, and they said, "You would actually pay in gold?" And I said yes. And they said, "Well, those would become negotiable instruments overnight and might even command a premium."

It seems to me that since we are off the gold standard, both internationally and domestically, there is no point in sitting on that treasure at Fort Knox, letting it gather dust. Can you see a flaw in that argument?

Mr. BOSKIN. Well, sir, I would like to take a more careful look at it, and I will ask my staff to make sure they get a copy of the details from your staff.

Let me just say that one of my goals at CEA will be to take a look at innovative financial instruments, and this certainly is one that is worth considering.

We do, just as an aside, carry the gold on the books at $42 an ounce or something.

Mr. CRANE. Right, $42.50.

Mr. BOSKIN. Which is one-eighth or one-tenth of its market price. So that leads one to some concern.

There are a variety of other issues that would revolve around your proposal, but I would be delighted to look at it in more detail. I am delighted to learn of it.

Mr. CRANE. It seems to me it is kind of a privatization scheme, in part, and I know that the gold is carried on the books, as you say, at $42.50 an ounce, which would not be that substantial a loss in terms of bookkeeping. But it sure represents, it seems to me, an alternative to what we are contemplating with the issuance of 30-year bonds. They are going to have to pay a competitive interest rate and compound our problems, you know, for the next generation or the next couple of generations.

Let me touch upon one other thing in your testimony here; that is, trying to promote freer and fairer trade. I am wholeheartedly in support of that. But we have had meetings with Carla Hills, and Carla says the European Community is adamant in its opposition to eliminating agricultural subsidies. When she and Clayton Yeutter met with their European counterparts, Clayton tried to get them at least to accept the notion of ratcheting down over the remaining years of this century their agricultural subsidies.

Because of our concern on this problem and their hard-nosed position—and the way she talked, they do not appear to be in a mood to compromise—it seems to me that it does not augur well for getting better trade relations in the agricultural area, at least, with our European partners. With their concern about the hormone beef and the like and our retaliation, this is something that could tragically start escalating in a hurry.

The reason I raise this is I and Chairman Gibbons are cosponsors of a free trade agreement with Japan, and I have since introduced free trade agreement legislation with Singapore, Hong Kong, Korea, and Taiwan. I know that there are some sticking points with Korea, certainly. I talked to people in Taiwan 2 years ago about this, and they appeared interested. Because Singapore and Hong Kong are free trade countries, we would have to make the concessions with regard to those two.

But do you see a problem in pursuing, while going on the multilateral track, pursuing these bilateral negotiations, trying to achieve free trade agreements?

Mr. **Boskin**. Well, I am fully in favor of any and all procedures that we can use to promote free and fair trade to pry open markets for American products. I certainly would agree that agriculture is sort of the key to the whole process, and that the bargaining will certainly be tough. But I have great confidence in Ambassador Hills and Secretary Yeutter. So I am hopeful that that Gordian knot will untie well before we get to EC 1992 and well before the year 2000 when we are hoping to have the agricultural subsidies phase out.

My only concern about bilateral free trade agreements, of which I think ours with Canada is a tremendous stride forward and should be a potential model, is that we have to be careful that in the process of doing this we do not create a system of incentives, if we move to other countries with bilateral free trade agreements, where everybody tries to line up their set of free trade agreements and we degenerate into a bunch of trade blocs which have some free trade agreements, then wind up with an unfortunate powerful pressure to raise barriers against the people that are not under the free trade umbrella.

I think if the Europeans did that and the Japanese did that and we did that, and then we all erected barriers among each other, even though we had a bunch of free trade agreements internally, I think that would be counterproductive.

So I think moving forward in a bilateral way, in addition to the multilateral way, in addition to the GATT, may have some substantial merit. But I would just be careful that we did not wind up inadvertently creating a situation where everybody was trying to divvy up who they had free trade agreements with and winding up throwing barriers up to others.

Mr. **Crane**. Thank you, Dr. Boskin.

Chairman **Rostenkowski**. Mr. Guarini will inquire.

Mr. **Guarini**. Thank you, Mr. Chairman.

Dr. Boskin, it is good to see you on the firing line again.

The prediction that is made of 3.5 percent of GNP growth this, of course, some feel are very optimistic. The first thing we see out there in the real world is Eastern Airlines, a death struggle between labor and industry. We know in Japan, West Germany, many other countries of the world that are leading industrial nations, labor and management has seemed to have gotten together and worked itself out. The President says that he is adamant against interfering, which is criticized by some as saying he chooses not to lead.

You have a very optimistic 3.5 percent GNP. If this strike wildcats, one of our major airlines may go into bankruptcy. I am sure that it is going to send certain kind of signals to the marketplace. It is going to affect a lot of numbers that we are dealing with this year, and I am wondering whether or not you are deeply concerned as an economist. What are the implications, the ancillary fallout? And how does that really affect what we are trying to do here today in regard to balancing the budget and getting our economy together, particularly in view of the fact that the President does not even choose to get in between and try to get these parties together? What are the implications, budgetwise?

Mr. BOSKIN. Well, first of all, sir, let me just add that the President and Secretary Skinner stated their reasons for their decision not to convene an emergency review board quite clearly, and I support them. But let me just get to the heart of your question, which is: What are the potential implications to the economy of the Eastern situation?

The implications to the overall economy, to real GNP growth, interest rates and so on are very minor, so long as this remains an Eastern problem. If there were a substantial, successful, extensive secondary boycott that disrupted the entire transportation system, without a pejorative statement, I personally would hope that would not happen, not only for the economy but for the transporting public. But, in any event, if that happened, then that could have some negative repercussions on the overall economy, on the delivery of goods and so on.

In the short term, I think what we will experience, if this is largely confined to Eastern, will be some minor delays for some particular delivers, and, of course, some substantial inconvenience for travelers, as well as obviously the substantial disruption to the workers and their families and to the other participants in the Eastern dispute.

Mr. GUARINI. But if there are secondary boycotts and it does wildcat out of control, then you would say there are serious implications on our overall budgetary process, and that you would have to make some recommendations to the President because of what is involved?

Mr. BOSKIN. Well, I would certainly say that if this became extremely extensive, it was likely to be sustained for a long period of time, and was so widespread that the whole transportation system was disrupted, that then it might well have an impact on our economy. It certainly would not drive us into a recession or anything like that, but it may mean that there would be enough delays and disruption that GNP could not grow quite as fast. That information certainly would be, and has been, indeed, provided to the President.

Mr. GUARINI. I agree this has to be watched very carefully.

Now, if we get down hypothetically to a point where sequestration becomes more attractive than the black-box solution—that is, if the President has to choose between sequestration or raising taxes—as an adviser to the President, if you have to choose between big defense cuts, which does have economic implications, or raising taxes, how would you advise the President?

Mr. BOSKIN. Well, if the President were in a hypothetical situation where negotiations with Congress had not proceeded to an acceptable agreement, where we were in a situation where we were facing sequester and he was given an either/or choice of raising taxes or sequestering, my advice under current economic conditions, and what I foresee to be the conditions of the economy with current data, would be that he should move to sequester.

I believe that it would be unwise to get into a situation where we did not have the fiscal discipline exercise. I would hope this committee would make sure it would do whatever it could to promptly get the process started so a budget resolution could be resolved.

But if the choice was, given my current information, between a sizable tax increase and sequester, which would have these specified, as you well know, sir, spending reductions, I would advise him to move to sequester. I think financial markets would prefer sequester. I think financial markets would like to see some additional discipline on the spending process.

Mr. GUARINI. Well, can you see any scenario at all in our economy as to raising taxes? Would you never say "never"?

Mr. BOSKIN. Well, of course, it is wise never to say "never." I think that I do not currently anticipate events occurring that would lead me to change the advice that I have given. But, of course, we get data on the economy every day. As we move into the spring and summer, we will have several more months of information, and a whole bunch of other things could change.

I do think it is worth emphasizing. I do not believe this is likely to happen, but in the most extreme situation where there was an unanticipated substantial down turn in the economy, we should use the escape clause in Gramm-Rudman and not move to sequester. We should temporarily postpone the targets if there was a recession.

Mr. GUARINI. Would that not send the wrong signals to the marketplace if we did that?

Mr. BOSKIN. No. I think the markets would understand that what we are trying to do at normal levels of employment is to get the budget deficit down. I do not think in the unlikely event that there was a substantial down turn in the economy that we should worsen it with a tax increase or a huge reduction in spending.

Mr. GUARINI. Thank you, Doctor.

Chairman ROSTENKOWSKI. Mr. Pease will inquire.

Mr. PEASE. Thank you very much, Mr. Chairman, and thank you, Dr. Boskin.

I am a little concerned that the fiscal year 1988 deficit, the actual deficit, was about $155 billion. The currently projected fiscal year 1989 deficit, according to OMB, is $163 billion. Clearly, we are moving in the wrong direction. Would you not agree?

Mr. BOSKIN. I would, although some of that is one-time events, like very large direct outlays for S&L's in early 1989.

Mr. PEASE. The other thing I am concerned about is the accuracy of OMB's projections. In late summer of 1988, for sequestration purposes, OMB forecasted the budget deficit for fiscal year 1989 would be under $146 billion. Now, some 6 months later, the current OMB under President Bush is forecasting $163 billion, or an increase of $17 billion in the last 6 months.

What kind of assurance will the financial markets have that we are really serious about deficit reduction if we cannot get more accuracy than that out of the official estimating body?

Mr. BOSKIN. Well, we would hope to have more accuracy than that. But let me point out, Mr. Pease, that, first of all, a large part—about two-thirds of that difference—occurs precisely because of what I just mentioned; that there was about an $11 or $12 billion then unanticipated, or perhaps not widely enough appreciate, outlay in support of S&L's in late calendar 1988, early fiscal year 1989. Second, there was a sharp rise in interest rates which had not been projected. Those are the two major things on the outlay side. The real growth of the economy, inflation, unemployment, have done about as projected or, in the growth case, even slightly better.

Budget forecasting will always be an imprecise science. We need to get it better. We need to be more accurate. We need to deal with reasonable and reliable alternatives, and I think we need—it is my own desire, and I hope that I will be able to implement this as midsession review, and I know other people in the administration desire it—not only to provide accurate and careful estimates, but also to provide enough sensitivity analysis so people can appreciate where outlays and receipts might change in response to various conditions. We have tended in the past to bury that sort of deeply in the bowels of the budget, and I would like that to be made much more clear.

We are required by law to produce a point estimate for triggering sequestration purposes, but it should be known, if we look at the history of forecasting, that in forecasting the deficit, forecasting interest rates, and forecasting GNP a year out or 2 years out, that the history of private forecasters, the administration, the Reagan administration, and the Congressional Budget Office is about the same. Namely, they are imprecise and some have been rosier than others, as some people described. The Reagan administration underforecasted real growth 4 of the last 7 years and overforecasted 3. The average estimated error in estimating GNP the following year is 2.5 percent plus or minus one-tenth of 1 percent for private forecast consensus, OMB—or, pardon me, the administration, which is CEA, OMB and Treasury, and the CBO.

So while I think we have to do better and I want to make sure that no games are played—and I think the deficit is a serious enough problem that it would be a major mistake for us to try to pretend we can sweep it under the rug just by coming to the midsession review and saying, My God, why don't we jack the growth rate up and lower interest rates still further—I think that this is a very important problem, and we must deal with it credibly. I could not agree more.

Mr. PEASE. Well, first, let me say I very much appreciate your apparent dedication to accuracy and your determination not to play games with the forecast next August when the crunch comes. I find it hard to believe we can get from a $163 billion deficit in fiscal year 1989 to less than a $100 billion deficit in fiscal year 1990. But that maybe could happen.

I would like to use my remaining time, Dr. Boskin, to ask if you might just carry a message back to President Bush. I believe that you are sincere, very sincere, in trying to get the deficit down in a responsible way. I believe you are correct that it is imperative that we act credibly on the deficit. I believe that you are also correct it is imperative that we act promptly on the deficit.

Indeed, in your statement, you say that the assumptions underlying your whole budget are that the Congress will act promptly on deficit reduction matters.

Whether deficit reduction comes through revenue increases, which are never popular, or spending cuts, it is going to be very difficult. The Congress is going to face some very, very difficult, sticky, politically hard decisions in the months ahead. I just hope you will pass along to President Bush that the sort of guerrilla warfare promised by Mr. Atwater and Mr. Rollins is distinctly not helpful in this process.

It will be difficult, in my view, in 1989 to get Congress to adopt a responsible budget package, whether it is increased revenue or very, very tough budget cuts, or spending cuts, when considered against the backdrop of the kinds of public statements that Mr. Atwater and Mr. Rollins have been making recently.

I also think that it will be virtually impossible to get any responsible action of that sort in 1990 after the election filing deadlines have passed. Every Member of Congress will know who his or her opponent is, and the targeting list of the GOP National Committee and Congressional Campaign Committee will become apparent. We simply will not be able to get Members to vote for responsible budgeting under those circumstances.

So it seems to me that President Bush really needs to make a choice whether he wants to deal effectively with budget deficits this year and next year, or whether he wants to continue standing by and condoning the guerrilla tactics of Mr. Atwater and Mr. Rollins.

Mr. BOSKIN. Well, sir, I will certainly bring that message back.

Chairman ROSTENKOWSKI. Mr. Chandler will inquire.

Mr. CHANDLER. I think Democrats ought to be nicer to Republicans, too.

Welcome, Dr. Boskin. You make two statements in your prepared remarks that I would like to get some more detail about, one on page 2, "And we must be especially careful not to adopt policies which are designed to raise private saving but do so at the expense of public borrowing." And then in the next paragraph, "The deficit must be reduced in a way that does not reduce private savings for that would just shuffle the problem of low national saving from the public sector to the private sector."

You are worried both about private savings and public borrowing. Maybe you could be a little more specific there of what you are talking about. What are you warning us about?

Mr. BOSKIN. Well, what I am trying to warn us about is that the major problem is not the budget deficit per se but the budget deficit's role in our low national saving problem. If we had the current budget deficit in a climate where we had much higher private saving, it would be having much less of a potential pernicious impact on our economy.

The two things that I was trying to warn against there were enacting something which was designed to try to assist private saving. IRA's come to mind. They were restricted in 1986. I personally think IRA's were somewhat successful in generating some new saving, but I understand this was part of a bigger compromise.

But if, for example, someone was to say let us reinstitute IRA's, one would have to be careful to score the revenue loss to the Treasury—and, hence, the larger budget deficit—against the increased private saving. So I was saying that one can conceive of proposals which sound very good and which might well have a desirable impact on private saving, but because they might lose some revenue up front—which might be made up later on when people take their money out of IRA's and pay taxes—that we have to be very cautious.

On the other side, if one were looking at various kinds of proposals which would try to close the budget deficit, one ought to be very, very chary of anything that would decrease private saving. If in looking at all of the receipts legislation that the President has proposed, and in its wisdom the committee chose to consider some other things which we would not consider wise—for example, further restrictions on IRA's—OK, that might raise a little bit of revenue, but it might be offset by having less private saving. And the national saving rate would not be affected. You might be able to say that would maybe help the budget deficit a little bit, but it would not affect national saving, the imports of foreign capital and so on. It would just be kind of shuffling between the public part, the Government part of the national balance sheet and the private part.

So I just wanted to make sure that in all of its deliberations, both of those things were kept in mind.

Mr. **CHANDLER**. Would you consider as a positive change no longer allowing the deduction of interest for home equity loans? My personal view is that the purchase of a home is probably the most important savings account a family can have. And when I see banks literally encouraging—I mean, not encouraging, they are almost flatly saying this is the only way you can possibly borrow these days, to take out the equity on your home. Really, what people are doing is taking that important equity, that important savings, and ending up consuming it.

Would that be a positive change, in your view, to adjust the tax law, if we are not going to encourage consumption through borrowing, to not encourage that consumption through equity borrowing any longer?

Mr. **BOSKIN**. Well, I certainly think it is worth considering in the more general class of issues concerning private saving, and in the various deliberations of this committee, following further down the path that it started in 1986, and I think correctly, to limit interest deductibility for consumer purposes.

It is a little bit tricky when you talk about home equity loans; because following through the exact sources and uses of the funds, whether these funds are really going into consumption or they really are being used for purposes of enhancing saving, whether in the house or for other of the allowable noble goals—education and health and so on—obviously is not an easy thing to monitor.

But I do believe it was a positive step forward in 1986 when the committee moved to limit interest deductibility for consumer purposes, and in that spirit, it certainly would merit consideration if the committee chose to reopen those issues. Your proposal would certainly merit serious analysis.

Mr. **CHANDLER**. OK. Thank you, Mr. Chairman.

Chairman **ROSTENKOWSKI**. Mr. Matsui.

Mr. **MATSUI**. Thank you, Mr. Chairman.

Mike, as a Californian, I would like to welcome you to the committee and also congratulate you on being appointed chairman of the Council of Economic Advisers. I look forward to working with you. I would have to say that Stanford's loss is certainly our gain back here in Washington.

Mr. **Boskin**. Thank you very much. It is a pleasure to see you again.

Mr. **Matsui**. And when I go back to Stanford, unfortunately you will not be there, but I am sure it will be in good shape with the President there and others. Again, in California we will miss you.

I would like to very briefly touch upon two areas. In answer to Mr. Pease, you expressed concern about raising taxes because of the potential negative effect it could have on the economy. I realize that if we raise taxes by $50 billion it probably would have a significant negative effect on the economy. If we raise taxes by some $25 billion, it would probably have a negative effect on the economy.

But let us say we had a $7 billion revenue raiser: a real tax increase, perhaps through base broadeners, or perhaps through small excise tax increases. With a $4 trillion budget, I find it hard to believe that would cause you, as an economist, a great deal of concern.

Will you please respond to that? Let us say a $6 or $7 billion tax increase out of a $4 trillion economy.

Mr. **Boskin**. Well, Mr. Matsui, I certainly would agree that the smaller the tax increase, the less the impact it would have on the economy; and that as you approach zero, the impact would be quite minor in its direct economic effects.

The additional economic concern which tends not to get mentioned when people trade off taxes against spending in this way is what sort of a signal it is sending to financial markets, which are very nervous about our ability to get our fiscal house in order and to keep the potential for explosive growth of spending under control.

There are always more potential noble claims for spending than we can afford, and I think that financial markets would be concerned if there was any significant give on the tax side. But if you are trying to say, to take an extreme, if there was one penny of new revenue would that have an impact, of course not. Certainly, I was referring to a situation where there was a slowdown in the economy. I would say that not only should a tax increase be avoided, but a very large spending cut should be avoided if the economy was in a down turn because that would worsen the down turn. So I was trying to be symmetric there. It is not just the tax side I was opposing.

The President has made it quite clear, however, that we believe that there are a lot of additional revenues already on line. There will be over $80 billion of revenue coming from the natural growth of the economy, and there are several billion dollars from various receipts proposals. We can leave capital gains aside because people have argued about whose sets of estimates are best for that. We believe it is likely to raise a little revenue. But even leaving that aside, we are talking about a few billion dollars from medical hospital insurance for State and local employees and getting them into the Medicare system; for repealing of the airport and airway trust fund trigger; for extension of the communications excise tax, which we have been doing periodically since the 1950's, as I recall, and so on.

So we believe a lot of additional revenue is coming in. We have also stated that we do not believe that there is a case for a tax increase at this point. I would make two points, in addition, sir. One is we have not ruled out a discussion. If negotiations start and there are people who honestly believe, parties to those negotiations, from either party and so on, honestly believe that additional revenues or additional taxes are desirable, we would be happy to hear them make that case on the merits. We do not believe from what we see currently that they are merited, but we have not precluded even discussing them.

The second point I would make, in addition to that, is that we would sort of like to try to change the way we think about budgeting into what we think of as a more common sense way, which is to think about how we are comparing what we are spending this year with what we are going to spend next year, rather than to a projected baseline. Therefore, combined with the Gramm-Rudman targets, we are in a situation where every additional dollar that would be raised by tax revenue actually now does mechanically reduce what slower spending growth will be by a dollar, because we will hit the target—if it is by sequestering or it is by agreement.

I was never a fan of an exact mechanical tax-and-spend argument, that for every $1 of taxes, spending will automatically go up $1, which was a popular refrain in the Reagan administration. Although I think there was some merit to it, I think it was too mechanical. We actually do now currently have—because of the vice that Gramm-Rudman puts on the thing, every $1 of additional revenue will result in $1 less pressure for spending growth.

Mr. MATSUI. In terms of the overall benefit to the economy, don't you think a small tax increase would be more beneficial than harmful in the long term if we need it to meet Gramm-Rudman targets and calm the financial markets, by letting them know that we are making a serious effort, not just a paper effort. If we are talking about, in a $4 trillion economy, $6 or $7 billion worth of taxes, and if that is the difference that is really holding up progress on reducing the deficit and getting a budget this year, it seems to me that we are fighting over very little, with great risk down the future, if we do not come to a resolution.

Mr. BOSKIN. Well, I think you have your numbers approximately straight. I am not going to argue those. I do believe that in negotiation that those points should be brought up and should be made. Certainly, the President is being advised of the likely economic effects of various combinations of ways we might meet the Gramm-Rudman targets.

I do not, as I said, currently believe that there is an alternative proposal on the table which I find superior to ours, which currently projects—and I think we can argue about the details of the projections—that currently has us meeting the Gramm-Rudman-Hollings targets without a tax increase.

Mr. MATSUI. Thank you.

Chairman ROSTENKOWSKI. Mr. Anthony will inquire.

Mr. ANTHONY. Thank you, Mr. Chairman.

I would like to follow up a little bit on Mr. Matsui's question. I personally have supported a 3-year surcharge, and my logic is this: That we all spent the money equally and we have all enjoyed the 6-

year expansion equally, so I think we ought to all pay the debt equally. I think a surcharge applied against a progressive income tax schedule would share the tax burden equally. I would do it for a short period of time, whatever percent that it would take to get us into a positive cash flow.

So where does my proposal hurt net private savings more than your proposal hurts net private savings. The money is still taken out of various people's pockets, and they cannot save it, and it goes to the Federal Government.

Mr. BOSKIN. Well, first of all, let me say if you are talking about a surcharge that would result in an increase in receipts more than the minor increase in receipts from the modest proposals that we have made——

Mr. ANTHONY. No. Let us go back. In President Bush's budget, what is the revenue number that you are looking for?

Mr. BOSKIN. Well, there would be slightly over $80 billion of growth between——

Mr. ANTHONY. I am talking about just in this first year. You propose user fees, et cetera, et cetera.

In other words, you do not recommend cutting the deficit by 100 percent spending cuts.

Mr. BOSKIN. Well, first of all, a large fraction of it occurs automatically by the large natural increase in revenue. Revenues will grow 9 percent by our estimate. They will be a little higher than that by the CBO estimate. And we allocate almost all, three-quarters of the growth in revenues to deficit reduction.

There will be some programs which decline naturally—for example, the farm program. We do not expect a drought. We have proposed various changes in other programs, reforms, which the one that has gotten the most attention is Medicare. We also have a few revenue proposals.

Mr. ANTHONY. Does that add up to about a third, about $14 billion?

Mr. BOSKIN. The revenue proposals for 1990, inclusive of capital gains, in 1990 add up to about $6 billion, in 1991 about $9 billion. It would be smaller than that if you excluded capital gains.

Mr. ANTHONY. I guess what I am trying to wrestle with is if you have got to have additional revenue, and you say you need more revenue, you just do not want it through taxation, you want it through some other source.

Mr. BOSKIN. Well, we need deficit reduction would be the way I would phrase it.

Mr. ANTHONY. Well, you can phrase it any way you want to, but it is revenue. To the person who pays this, it is revenue When they pay it out, they are not going to call it deficit reduction; they are going to call it "My taxes have been raised; I have got less money to spend; I have got less money to save." That is how John Doe is going to see it down home. You can call it anything you want to. They are going to have less money to spend. The Government is going to have more money to do whatever they want to with it.

I am serious about this. What is the difference between the same amount of money coming out of pure taxes on a short-term basis, on a surcharge equally across the board, than all of the hybrid ways in which you would raise it? You just mentioned three. A proposal to get local employers into Medicare takes congressional action. This committee has looked at it since 1986. We have rejected it on three or four separate occasions. It is not Democrats who are fighting against it. It is Bill Gradison from Ohio who is fighting against it. Repeat the airport trigger, that takes congressional action. Extend the telephone excise tax, that takes congressional action.

So I am saying if you have got to have congressional action on those three, what if we disagree with those three and say we will bring in the same amount of money only we do it with a surcharge? What is the difference in the net private savings, and why would that jeopardize the 6-year expansion versus the way you want to do it?

Mr. BOSKIN. Well, let me just say that these particular receipts proposals were done because, among other things, we think they are sensible policy, quite aside from their small positive impact on revenue. Let me say if you are talking about several billion dollars of surcharge offsetting these types of things, and you are asking just a purely technical question is, what the difference is on saving, these tend to be either fees or charges on consumption rather than on saving.

An income tax taxes both consumption and saving. It would be less harmful to saving than revenue which came directly, say, by further limiting IRA's or tax deferred saving. But it would have a small impact on saving relative to fees which hit directly consumption. But the effect would not be large so long as the number was on the order of magnitude we are talking here.

Mr. ANTHONY. I will just close by asking one other question. Why would the administration propose capital gains for only a very limited definition of assets? And I will speak parochially now. I represent 23 counties in south Arkansas. It is a very, very heavily timbered area; seven of the largest timber companies in the United States have plants there. They provide the largest number of employees, capital expansion, and growth in economic opportunity for us in our part of the country. The product that they need for the future is trees for the pulp, for the paper. It takes 50 years to make it merchantable.

Could you explain the logic behind refusing to give them a capital gains treatment versus just a stock certificate in Eastern Airlines, who is laying off employees rather than creating employment?

Mr. BOSKIN. Well, let me first say that I will bring this information back, and pay closer attention to it, and make sure that Secretary Brady and the Treasury people have it.

The general goal was to try to limit the capital gains proposal to exclude things like collectibles, and so on, where people might just get—purely get rich.

Mr. ANTHONY. Well, a tree is not a——

Mr. BOSKIN. I agree. Trees are not like Persian rugs. I could not agree——

Mr. ANTHONY. And it is not an antique rug. It is not a painting on the wall.

Mr. BOSKIN. I could not agree with you more, sir. Second, there was a concern that we not get in a situation where shelter activity could be increased. I will have to inquire the extent to which that either was historically, or could be the case in timber, and I will get back to you with an answer on that. Maybe that was part of the concern.

I share your concern about the employment effects.

Mr. ANTHONY. You are not going to run into anybody sheltering any income going into the timber business, I can promise you that, because there were a lot of other things that were taken away at the same time.

Mr. BOSKIN. Well, I will get you back an answer to that particular question, sir.

[The information of Mr. Boskin follows:]

I understand your view and concern about the way the Treasury proposal to reduce capital gains taxes treats timber. Treasury economists carefully considered many aspects of capital gains taxation in developing its proposal.

Treasury's rationale for maintaining the status quo on tax treatment of capital gains on depreciable and depletable assets is that income from sale of business assets should be treated as ordinary business income. Treasury maintains that timber already receives favorable tax treatment from the immediate deduction of growing expenses and depletion allowances.

Treasury has sought to limit the capital gains preference to long-term investments most responsive to the rate reduction. It has argued that the timing of timber sales is unlikely to be significantly influenced by its tax treatment.

Mr. BOSKIN. Let me just say that the proposal was designed to try also to deal with the issue of the double taxation of corporate equity, the bias in our tax system toward debt, away from equity, and a variety of things of that sort.

Originally, there were various proposals floating around in the administration, and out, just to limit it to common stock, and I guess we went a little broader than that, but I will get back to you on the timber business.

Mr. ANTHONY. My time has expired. Thank you.

Mr. BOSKIN. Sure, Mr. Anthony.

Chairman ROSTENKOWSKI. Mr. Sundquist.

Mr. SUNDQUIST. Thank you, Mr. Chairman. Dr. Boskin, thank you for your testimony.

Briefly, Dr. Boskin, would you comment on where we are headed in terms of employment, and unemployment in this country in the next few years. Please give us the optimum percentage of employment or unemployment, and then touch on the impact that a healthy economy has relative to the pressure of employment.

In other words, does a healthy economy necessarily mean more inflation? Would you comment in that area.

Mr. BOSKIN. I certainly will. It is the administration's goal, and it is my professional view as an economist, that we want to try to create an economic environment that provides employment and employment opportunities to anybody who may wish to work. Additional jobs for people who might wish to change jobs currently; for the new entrants to the labor force; for people who might wish to enter or re-enter the labor force, of whatever age.

I think it is a remarkable achievement of our economy, that we have been able to raise the fraction of our population working in the marketplace substantially, to a record high. We have been able to absorb the baby-boom generation, and the increased female labor force participation, and kept unemployment relatively low.

There are other societies, notably Western Europe, which have more or less permanently disenfranchised a large fraction of their population from the market economy, and I think that is economically unsound as well as immoral.

Therefore, it is my own view that we ought not to be passive, that we ought to try to challenge the ability of our economy to provide that employment and those opportunities.

As the unemployment rate is headed down into the low 5 percents, there have been people who have said that necessarily implies a big increase in inflation. I do not agree with that view.

Certainly there have been these mixed signals I refer to. There may be a slight increase in wage costs for a while but we have seen a big increase in the labor force participation rate. People have moved into the labor force. It is not just existing employees that have had wages bid up. I believe that we can run sound economic policies of low unemployment, of high employment, without serious risk of a major expansion in inflation.

Inflation is bad. We must keep it down. We must not run policies which try to make temporary gains in unemployment at the expense of a big increase in inflation because that will just mean a recession later on when we try to disinflate.

But with matter matching of skills to jobs, with various other types of improvements in the flexibility of our economy, I believe the unemployment rate can stay where it is now, or decline, and I certainly believe we will be capable of seeing substantial increases in employment over the years ahead.

Mr. SUNDQUIST. What do you foresee in terms of women in the workplace? Have we reached probably the optimum in that percentage?

Mr. BOSKIN. Well, there certainly has been a very large increase in the fraction of women working in the market economy, and the fraction of second-earners, two-earner families. I certainly believe that the steepest part of that growth curve is over, but I think the growth curve will continue. And I think if we look back 20 years from now, we will see that the fraction of women working in the market economy has grown.

Mr. SUNDQUIST. Do you see a shortage of workers in the next 5 to 10 years?

Mr. BOSKIN. It depends on what you mean by a shortage of workers, sir. I do not mean to be rhetorical. I certainly do believe that demographic factors will make it more difficult for the labor force to expand as rapidly as it did in the past as the changes in the birth rates, that we experienced some years ago, will move to a slower growth of the natural 18- to 21-, or 22-year-old population coming up each year for entry into the labor market.

But there are certainly other pools of untapped resources. This committee led the fight for what I believe to be one of the most important pieces of legislation which is the gradual phasing in, in the early part of the next century, of increased ages of retirement for full eligibility for Social Security, consistent with the changes and the reforms in mandatory retirement law.

So we may well be capable of having people work a year or two longer, having more of the elderly decide that it is desirable, particularly if we can deal with some of the tax disincentives that Congressman Archer mentioned.

So I believe there are pools of potential labor out there, if people decide that it is in their interests and they desire to come back to work, or to enter the labor force.

But I do believe the natural growth of the labor force at the younger end is going to be slower for a few years.

Mr. SUNDQUIST. Thank you. Thank you, Mr. Chairman.

Mr. MOODY [presiding]. Mr. Coyne will inquire.

Mr. COYNE. Thank you, Mr. Chairman. Dr. Boskin, it is my understanding that you are going to be doing a review of some of the Government statistics.

Mr. BOSKIN. That is correct, sir.

Mr. COYNE. Which ones will you focus on, particularly?

Mr. BOSKIN. Well, sir, let me first state that it is my responsibility under the Employment Act of 1946, as subsequently amended, to evaluate, report on, and produce and disseminate information and trends on the economy.

My staff and the Council of Economic Advisers produces Economic Indicators with the Joint Economic Committee for dispersal to the Congress, to try to give them the best updated information we have on the economy.

I provide daily information to the President and other senior administration officials in that regard.

So, first, just discharging my own particular legal responsibilities, statutory responsibilities in my job, require me to evaluate the quality of the information I receive, virtually daily, from all of the statistical agencies. So it is going to be a broad-ranging analysis.

Now there are two sets of things that I might particularly focus on, or two categories. One is factors that reflect some rather substantial changes in the economy. For example, that the goods-producing sector and the service-producing sector have changed relative weights, and our service-sector statistics might be improved. That is one example.

Or productivity numbers in the service sector, new products, getting quality change into the measures of GNP, and so on. Those are fairly important, I think, to get a real handle on exactly what is going on in the economy.

There are some very talented people, and all the statistical agencies, working very hard under some rather severe constraints to get out the existing numbers, and to try to generate new projects, and we want to coordinate with them, to try to up this more to the front burner than the back burner.

And another set of statistics along that line would be the trade statistics. Trade is much more important now, and I think the general feeling is the trade statistics have not been of as high a quality as other parts of our national income accounts.

The second set of things I would like to do would be, in addition to trying to make suggestions, evaluate the existing statistics and make suggestions for improving them, would be to come up with what we believe to be useful supplementary or additional statistics.

The Federal Reserve has some data that it generates, the Commerce Department has other data it generates, which have somewhat different measures of saving, and they are conceptually different, and I would hope that we can play a role in improving the general public as well as administration and congressional understanding of these key things.

Mr. COYNE. Well, of particular concern to me would be the unemployment statistics, to the extent that they do not include discouraged workers and part time workers. Do you have any intentions of taking a look at the validity of the way we compile those statistics?

Mr. BOSKIN. I certainly do. As I am sure you are aware, Mr. Coyne, that we do inquire of people who are working part time as to the reason they are working part time, and the overwhelming bulk of those people do not list economic reasons but, rather, other circumstances, family responsibilities or things of that sort.

But that is certainly one of the things we would be looking at.

Mr. COYNE. So that is something you will be reviewing?

Mr. BOSKIN. Sure.

Mr. COYNE. In your response to Congressman Guarini relative to a choice between sequestration and a possible tax increase, or revenue enhancement, you indicated that you would probably advise sequestration, and I just wonder, if that is the case, do you think a credible deficit reduction package can be put together without additional tax increases?

Mr. BOSKIN. I believe it can, and obviously we require a lot of hard work, prompt action, and a lot of good will on the administration and the Congress' part. We are ready to enter those negotiations as soon as Congress is ready.

Let me just say that this administration is not going to try to assess blame to someone else for anything unpopular, and grab credit for all the popular things. I think there are ample historical precedents. The 1983 Social Security Amendments, the 1986 tax reform, where everybody was upset about some pieces of the legislation, and some constituents were, but that credit for the general good was shared, as well as blame for the unpopular things, and we would expect that to be the case. We are hopeful.

We believe we presented such a set of proposals, and there is a whole category of things in there. Rather than specifying item by item, we said, look, let's negotiate on these things, and decide—not present to you a long list of programs that President Reagan proposed eliminating, that the Congress has repeatedly refused. Let's discuss which ones should be reduced, which ones should be increased, and so on.

So we are prepared to entertain, and to discuss any credible deficit reduction program that meets the Gramm-Rudman targets, that is responsible, and that is debated and discussed on its merits in negotiations.

Mr. COYNE. What do you think the reaction might be of the markets, and foreign nations, to the possibility of sequestration being the ultimate outcome of all of this?

Mr. BOSKIN. Well, I believe that financial markets would breathe easier if there was an orderly negotiated prompt deficit reduction package, that credibly put the deficit on a downward substantial path, not just for this year but for at least 2 years, and for the foreseeable future.

I believe that is very important. If we just kind of squeeze through this year, and then we have the problems that the chairman and others have mentioned about the following year being an election year, and so on, and the heat—not being able to do anything.

I think that would be very, very damaging to the financial markets' confidence, and might have deleterious consequences. I do believe that if we get late in the game, that it would be intolerable not to sequester.

I think that failing to sequester would be viewed by financial markets as kind of opening up the dike, and I think that would be very, very bad. I think that we must be willing to sequester, if necessary. We believe it would be better Government to come to a negotiated settlement well before that time.

Mr. COYNE. Thank you.

Mr. MOODY. Mr. Jenkins.

Mr. JENKINS. Thank you, Mr. Chairman. Good to see you again, Dr. Boskin.

What is your greatest concern in the next 2 or 3 years, inflation or recession? I understand you have a concern about both.

Mr. BOSKIN. Let me just say that there are very substantial real and human costs of recession. I do not currently foresee a recession in the works, but we know that we must be vigilant against external shocks to the economy, against policy mistakes and to monitor to make sure that there are not imbalances being created in the economy.

My own personal view is that we need to be equally vigilant against both for two reasons. First, if you let the inflation genie out of the bottle, what you wind up having is inflation ratchets it up to 7 and 10 and 13 percent. You get into an intolerable situation that is not only bad because the inflation is bad, but then when you go to get the inflation genie back in the bottle you almost certainly have a recession that may well be severe.

Mr. JENKINS. With the policies of the Federal Reserve, is it more likely that we would have a recession than inflation in the next 2 or 3 years?

Mr. BOSKIN. I think the policies currently in place have created an environment in which we can arrest what may have been a slight increase or at least certainly a concern about an acceleration of inflation over the next year or so, and do so in an opportunity that would prevent us going through a sharper downturn as a recession.

But monetary policy does work with long and predictable lags, and hence we need constantly to be vigilant that we haven't either overdone it or underdone it. So I think that we need to monitor these data continuously, as I said that we will do, and I am optimistic that we can avoid both an acceleration of inflation and a recession.

But I don't mean to duck the question. I am equally concerned about. I am concerned about inflation because it is bad per se. Because if you let the genie out of the bottle it will be a worse recession down the road. I am concerned about a recession because we do not need to have one. Our economy can continue to grow for some substantial length of time without a recession.

We have seen ample evidence of that in other economies which have had long uninterrupted periods of economic growth without a downturn. So I think we need to have strong standards of performance against which we would like to see our policies operate.

That isn't easy. The Federal Reserve has a difficult balancing act, and I guess I, in addition to the other concerns I have expressed about the budget deficit, the moral, ethical and other, and financial market concerns, I think the best additional reason to reduce the Federal budget deficit it give the Federal Reserve a little more elbow room. They are squeezed right now, worrying about the effect on interest rates that is going on because of uncertainty about resolution of the budget deficit.

A credible deficit reduction plan will almost certainly take substantial pressure off of interest rates, make their job a lot easier, and take a substantial step forward in coordinating monetary and fiscal policy in a way that helps to prevent the possibility of recession.

Mr. **Jenkins**. Of this $80 billion in increased revenues that we will have this next year, how much of that is in Social Security, Medicare trust fund, airport trust fund, highway trust fund, and other dedicated trust funds? How much of the $80 billion is general revenues?

Mr. **Boskin**. Well, the largest component is general revenue, but there certainly will be an increase in Social Security, I believe.

Mr. **Jenkins**. Over half of it is into these various trust funds?

Mr. **Boskin**. I do not believe that is accurate. But, if you hang on 1 second, I will——

Mr. **Jenkins**. If you include catastrophic as well as Medicare, airport, highway, and Social Security?

Mr. **Boskin**. I am looking for the exact data, and if you will bear with me for 1 second.

Mr. **Jenkins**. While you are looking for that, let me——

Mr. **Boskin**. I believe the majority is in the general fund, but it is certainly correct that there is a substantial amount of increase in Social Security and other so-called trust fund receipts.

Mr. **Jenkins**. I am of the impression that over half of that is into the dedicated trust funds.

Mr. **Boskin**. Well, I will get you the exact number as soon as I can find it. I am sorry, I don't have it with me.

Mr. **Jenkins**. Regarding the savings we talk about capital gains differential, which I have generally favored, and recognizing the need for private savings, wouldn't we be better off economically maybe to simply take savings accounts, maybe with a cap, but just simply give tax-free treatment to individual savings account, than we would to go with a differential in capital gains if we have a long-term loss from capital gains, a differential? Just simply have a $50,000, $100,000 cap, tax-free treatment, period?

Mr. **Boskin**. Well, let me first reply to your other question. I found the table. The projected increase in receipts from individual and corporate taxes would be about $56 billion. The projected increase in social insurance taxes and contributions, so-called off budget, would be about $21.5 billion.

Mr. **Jenkins**. OK.

Mr. Boskin. There is a slight decline in unemployment insurance receipts and other miscellaneous types of things. Excess taxes go up a billion, and so on. But the bulk is in individual and corporate tax receipts, but there certainly is a nontrivial increase in Social Security receipts.

Let me just say that the capital gains tax reduction, as opposed to, say, tax-free saving more generally, would affect saving in different ways. It would affect who does the saving and for what purposes. A capital gains tax would be more targeted on entrepreneurial effort—a capital gains reduction.

Tax-free saving accounts, if we could avoid the problems of losing revenue and the increased budget deficit, would raise the available supply of funds in general and would not necessarily be targeted particularly to entrepreneurial effort or the longer term kind of investment effort that the 3-year phased in holding period that Treasury designed and the administration adopted is designed to do.

Mr. Jenkins. Well, it would appear to me that the banks and so forth that held those deposits would be making investment.

Mr. Boskin. Oh certainly. Those funds would find their way into productive investment.

Mr. Jenkins. But you think the capital gains would be better than a tax-free treatment of interest received by individuals?

Mr. Boskin. I think it would be different. I would hate to use the word better or worse. I think, if we had the revenue, the kind of single taxation of saving to which you are alluding, rather than the double taxation of saving inherent in an income tax, would be highly desirable as a general policy goal.

I think the capital gains is a more targeted issue, targeted to things like the double taxation of corporate equity income, reducing the tax bias to debt financed longer term investment entrepreneurial effort as opposed to the general pool of saving and investment.

Mr. Jenkins. Thank you for your testimony, Dr. Boskin.

Mr. Boskin. Certainly, Mr. Jenkins.

Mr. Moody. Thank you. Well, it is a pleasure to have you before us, as others have said. I think when we were on the Berkeley campus some few years back I don't think we would have expected to be facing each other across this particular forum.

Mr. Boskin. Well, it is a pleasure to see you again, Jim. If I can call you Jim at this time.

Mr. Moody. Please do.

Mr. Boskin. Mr. Moody.

Mr. Moody. No, no. Please.

Mike, I certainly applaud the administration's emphasis on human capital and on the investment accounts in the budget, particularly the human investment accounts. But despite President Bush's well-publicized emphasis on education, in fact, my understanding from my own congressional budget people is that spending on education in totality actually goes down. It is a little hard to tell because it is in the so-called black box. But, although some of the subcomponents go up, the total education spending goes down. Is that your understanding?

Mr. **Boskin**. Well, no. Precisely because a substantial number of programs are in the so-called black box. Obviously, this President is much more prone to eliminate those programs than the previous President and that subject is in negotiation. Those not only could stay the same, they could even go up.

But there were some carefully targeted human capital initiatives with respect to education and child development, including daycare and adoption. But on the human capital side, merit schools, merit pay, magnet schools, and a variety of other proposals, were made initiatives among the very small set of new initiatives that we thought were important enough that we could take funds away to try to get a start on those. Education was one of the things at the top of the list.

Now it could be that in negotiations that things happened to these other programs that reduced them sharply, so perhaps some total category called education might change or might go down rather than up. But I think that within the group that the President is predisposed to limiting the reductions that occur in the education component of the black box.

Mr. **Moody**. That is a subject of negotiations, then.

Mr. **Boskin**. That is right.

Mr. **Moody**. But the President has not come out and said we need to spend more on education in the total sense. That is not part of the explicit budget request?

Mr. **Boskin**. Not as part of the explicit budget request, but it will certainly be dealt with in negotiations over what is called the black box, or, indeed, over the whole set of proposals.

The President believes that it is important that we expand our commitment to education, not just our financial commitment but our commitment across the board. He also believes that that is in part a responsibility of families and individuals and local and State communities, rather than just the Federal Government.

But there is a substantial commitment in a variety of areas that he has marked out under new initiatives in education.

Mr. **Moody**. Let me now switch to items more directly of concern to this committee. Education is not especially our purview, of course. Let me start with a comment.

It seems to me that what we are all concerned about here is the credibility of any deficit-reduction package we put together. Not only the credibility, Mike, but the long-term nature of it. It is not just a quick fix or a 1-year shot.

With that in mind, and I gather from what you have said already this morning that you agree with that, let me ask you about a couple of things starting with the capital gains proposal.

It is true that the debate rages on between the technicians as to whether this proposal gains revenue on a 5-year basis or loses revenue on a 5-year basis, and, as you point out, on a 3-year basis it comes out very close. But, in the longer term it certainly does not.

Given the fact that we have a wide swing in 5-year estimates here, a $35 billion swing, it seems to me the risk of overshooting is very different than the risk of undershooting. There is an asymmetry in the risk because of the desire to meet Gramm-Rudman targets and all of the market effects, the signal effects, if you will, that that has.

One could argue that you should pursue a mini-max approach here. That is, you want to minimize the maximum bad thing that can happen to you. And certainly, drastically underestimating the revenue or finding yourself with a revenue loss whereas you expected a revenue gain, each dollar of that in that side of the risk distribution is much more serious than the possibility of overshooting.

Would you want to comment on that?

Mr. BOSKIN. Well, I certainly agree that in the current budgetary climate we have got to be very chary of anything that might lose revenue.

Mr. MOODY. Right. An asymmetrical risk.

Mr. BOSKIN. That is a very substantial and important thing. That I agree with.

The second point I would like to make, however, Mr. Moody, is that these estimates, both of the Joint Tax Committee and of the Treasury, leave out all effects on GNP. They are effects of changes in the portfolios and so on. There are many people, myself included, who believe that the reduction in the capital gains tax will generate some increased entrepreneurial activity, not just portfolio shuffling and so on, and not just realizations out of the stock of assets, and that will have a beneficial impact on the economy. That need only be very small to offset these other potential losses that you are discussing.

Now, I certainly would agree that, while I think you get some general agreement about the sign of that effect, its size is very difficult to quantify. So I think that you would be right to be concerned about any potential revenue loss, but I do believe that Treasury has done a first-rate job in doing these estimates, and we are in the process of trying to track down the exact disagreements with the Joint Tax Committee.

Mr. MOODY. But you don't disagree with the appropriateness of the risk averse strategy in this regard?

Mr. BOSKIN. No. That is why in my own testimony, as you may recall, I suggested, while I am strongly in favor of trying to increase the private saving rate, we have to be very chary that we not do so in a way that inadvertently increases the Federal deficit.

Mr. MOODY. OK.

Mr. BOSKIN. Let me just—I now have the numbers in front of me on education, and I will say that the proposals are for an increase in outlays in the Department of Education of $768 billion between fiscal year 1989 and fiscal year 1990. Now clearly that could change, depending on the resolution of these negotiations.

Mr. MOODY. That is the total figure, then?

Mr. BOSKIN. That is the total figure for the whole Department of Education.

Mr. MOODY. Thank you. Back to the question of risk and the question of the audience, the market. The administration, of course, is proposing to take the S&L crisis, which is of huge dimensions, and basically solve it in a way that makes Gramm-Rudman look better than if we solved it some other way. There is the off-budget/on-budget debate, and so forth.

Wouldn't the market, that audience out there, feel better, breathe better, to use your own term, if we were to deal with the

S&L crisis in the most straightforward way possible? If that included putting it on budget, so be it, with a lower basis point penalty for having it on budget, which everyone agrees there would be, that interest rates would be slightly less—some people have mentioned 25 basis points less. And we could then amend the Gramm-Rudman targets explicitly to take account of this and only this, so that this would be the reason why we are allowing the $100 billion to be $114 billion, or whatever we would be. In other words, we could adjust the Gramm-Rudman targets for this very extraordinary event.

You said earlier in testimony that you think if we had a recession we shouldn't blindly follow Gramm-Rudman targets, we should adjust them because of the extraordinary event.

Well, here is an extraordinary event, the S&L crisis. Isn't there an argument that we should treat it as an extraordinary event, adjusting the Gramm-Rudman targets precisely and surgically only for that, not to open them up for everything that one might want to fit under them, and achieve the solution at the lowest possible interest cost to the public, rather than trying to meet the nominal targets of Gramm-Rudman by pushing something off budget?

Mr. BOSKIN. Well, I certainly agree that there is some merit to considering—to the statement you made. I do, however—I am, however, very concerned about opening up Gramm-Rudman. You expressed concern as well, Mr. Moody. While this is an extraordinary, in a sense a one-time event, most of the problems already occurred. There may be a little more as we resolve the insolvent thrifts.

Mr. MOODY. The quicker we act, the less there will be.

Mr. BOSKIN. That is right. But I think that there is—I have a concern that, if this might be a good reason, there might others that are pretty good and so on, and then we would wind up having the whole Gramm-Rudman discipline process break down. So that is one concern. I think the markets would be very concerned about that.

You are quite right that there may be a very modest interest differential in the financing mechanism, and that is one of the factors that had to be factored in in evaluating the overall options that the Treasury prepared and the President decided upon.

But I also believe that the financial markets are pretty sophisticated, and I think they can follow where the cash flows are and what is going on, and so forth, and I think they understand that this is a one-time event and how it is being done. And I think that the overwhelmingly important thing is the twofold fact of coming forward with a plan and getting it in place quickly, and I think it is much less important about whether we are dealing with one-eighth of 1 percentage point or a quarter on the interest rate. But getting a plan in place quickly and getting the situation resolved, and, secondly, that that plan not focus just on the financing mechanism. We have to also focus on reform of the incentives in the system. The administration plan does that with higher capital requirements, with changes in accounting, with getting more private capital out front in terms of the risk, and so on. And there have been a variety of other suggestions, some coming out of the two Banking Committees and so on.

It is absolutely to the way this is perceived by financial markets as well as to the subsequent operation of the S&L industry and financial institutions in general that a sensible reform package be coequally important as the specific method of financing the problem that has already occurred.

Mr. Moody. Thank you. Turning now to the economic assumptions part of your testimony, you said that the difference between the CBO and the Blue Chip or consensus forecasts and the administration's pale by comparison to the decisions we have to make in these two chambers about spending and other key issues.

Mr. Boskin. And the natural growth of revenues.

Mr. Moody. And the natural growth of revenues; right. And yet we are told by Leon Panetta's budget staff, that the difference between the CBO and the administration in assumptions amounts to $10 billion in 1990, $10 billion on the deficit.

Well, $10 billion is not a very small amount of money. In fact, that exceeds the amount we spend on energy. It exceeds the amount we spend on housing or commerce. In fact, it exceeds the amount we spend on those categories all combined. It exceeds the amount we spend on community and regional development. It exceeds the amount we spend on law enforcement, and we have got some real law enforcement problems. It exceeds the amount, in fact, that we spend on general government. So when you try to find $10 billion right now in this budget environment, that is no small task, cutting $10 billion.

Mr. Boskin. I couldn't agree more, and I didn't mean to suggest that that was not a very difficult task, nor a very important task. I just meant to compare the $10 billion to the $70 billion we are trying to get, and that the economic assumptions are not the major issue. They are an important issue. They do make a difference, and we have to pay attention to them.

But, if we are talking about going from 170 to 100 or slightly under, they are one-seventh of the total, if we compare, say, the CBO estimates and the administration estimates.

Mr. Moody. But the last $10 billion may be more difficult than the first $60 billion. I mean, there is a nonlinear relationship between them as you cut deeper and the difficulty of cutting.

Mr. Boskin. You are certainly correct that much of that, much of the—some substantial fraction of this will occur because of a substantial growth of revenue and probably the last dollar of cutting may be harder economically and/or politically than the first dollar. I would certainly agree that is a general principle. And I can assure you that we will do the best job we can in doing the midsession review.

I was only trying to compare—I was only trying not to divert attention from or to make sure we didn't delude ourselves into thinking that only if we change the economic assumptions that we are going to create such a monumental problem that was insoluble relative to what was already in the plate.

Also, reducing the budget deficit from $170 to $105 versus $95, or whatever the numbers that you are talking about with the $10 billion, most of the impact on interest rates will come from the first $65 billion of that, not necessarily the last $10. There will still be an additional little impact on interest rates.

Mr. Moody. Right. Well, except if we miss the Gramm-Rudman by $5 or $10 billion——

Mr. Boskin. No. We ought to be within Gramm-Rudman.

Mr. Moody. Of course. But, if we miss it because of that $10, then that $10 has a disproportionate—that missing $10 has a disproportionate effect on interest rates because of the signals that it will send to the market about lack of discipline in this body.

Mr. Boskin. Well, I would agree with that up to a point, but I would doubt that it would be on a magnitude—well, I don't approve of that as an outcome. I strongly disapprove of it. It would certainly be less than the reduction from $170 to $105 would create, and it would certainly—and in view of what has happened the last couple of years, where we have not made what we thought were going to the targets we were going to make, it would be a big improvement.

Mr. Moody. Right. Well, I only meant to point out that we don't want to be too cavalier about the $10 billion difference in estimations.

Mr. Boskin. I think we shouldn't be cavalier about anything. I think that in doing the programmatic issues that you have to deal with as a committee, I am sure you are not at all cavalier about a few million dollars, let alone $10 billion.

Mr. Moody. Yes. Right.

Mr. Boskin. I do want to point out again that we are talking about a $70 billion reduction coming out of increase in revenues.

Mr. Moody. Well, many of us feel it is going to be hard to meet $70 billion without some revenues.

Mr. Boskin. I understand that.

Mr. Moody. So when we start doing it all on cuts, or predominately on cuts, and we talk about $5 billion out of Medicare, that sends people pulling their hair out over in the medical establishment. So $10 billion begins to be a very big number when you look at some of the ways we are going to be trying to find $5 billion here and $5 billion there.

Finally, my last question is on tax increases. The President is dedicated to no new tax increase, and yet in his proposal he puts State and local employees under Medicare. While I think that is not a bad idea as a policy matter, I wonder if it meets the duck test in your estimation?

Mr. Boskin. I do believe it meets the duck test.

Mr. Moody. So it is a new tax?

Mr. Boskin. I believe that, while that will, obviously, produce a flow of revenues, it will also produce a flow of outlays on the other end. These people will be covered by Medicare, and that should more properly be viewed primarily as an expansion of Medicare coverage.

Mr. Moody. So you do not consider it a duck? It is not a tax?

Mr. Boskin. I think that the Budget Director and the Treasury Secretary are probably better at these semantic arguments than I am, but I don't think it violates the spirit of the President's no-new-taxes pledge.

Mr. Moody. Because of the benefit flow that attaches to it?

Mr. Boskin. That is right.

Mr. **Moody**. OK. Those are all my questions. Do you have any final comment you would like to put on the record?

Mr. **Boskin**. No. I just wanted to repeat to you, Mr. Moody, and to your colleagues the appreciation I have in your having me before the committee, and to reiterate that I and the entire Council of Economic Advisers will do everything we can, not only in the budget process but anything under the purview of the committee to be as fully cooperative with you and your staff and provide you with the best professional information we can as in humanly possible.

Mr. **Moody**. Thank you for that offer. I know that all of the members of this committee appreciate that, and I, for one, would like to sometime come down and look at your own black boxes to see how you do what you do.

Mr. **Boskin**. I would be happy to give you a tour of that as well as the office, sir.

Mr. **Moody**. OK. Thank you very much.

[Whereupon, at 12:30 p.m., the committee was adjourned, to reconvene subject to the call of the Chair.]

THE BUDGET DEFICIT, THE STATE OF THE U.S. ECONOMY, AND FEDERAL BUDGET POLICY FOR FISCAL YEAR 1990 AND BEYOND

WEDNESDAY, MARCH 15, 1989

House of Representatives,
Committee on Ways and Means,
Washington, D.C.

The committee met, pursuant to notice, at 10 a.m., in room 1100, Longworth House Office Building, Hon. Dan Rostenkowski (chairman of the committee) presiding.

[Note: Due to a scheduling problem, Secretary of the Treasury Nicholas F. Brady presented testimony both on the subject of this hearing and the subject of the troubled savings and loan institutions. The testimony is being printed in both hearings.]

Chairman Rostenkowski. The committee will come to order.

Today the Ways and Means Committee continues its hearings on several topics.

First, this morning we will receive testimony from Nicholas Brady, the Secretary of the Treasury. Mr. Brady will discuss the President's proposed fiscal year 1990 budget. In addition, Mr. Brady will testify regarding the administration's proposal to assist trouble savings and loan institutions.

With respect to the President's budget, I am disappointed that the administration continues to use unrealistic economic assumptions, and that the capital gains tax rate reduction proposals have been put on the table. I believe deficit reduction is our highest domestic priority. As I have said many times, deficit reduction is going to require a balanced package of tax increases and spending reductions.

In addition, this committee has conducted several hearings regarding the budget implications and current tax rules relating to troubled savings and loan institutions. We heard disturbing testimony regarding the use of those special rules in transactions closed in December of 1988 by the Federal Home Loan Bank Board.

In addition, we received many comments regarding the administration's proposal to assist troubled savings and loan institutions. Several witnesses expressed concern over certain aspects of the proposal, including the off-budget treatment of payments of principal on bonds to fund the assistance plan, and that the potential costs of the assistance will far exceed current estimates.

This committee has jurisdictional concerns regarding the administration's proposal, including issues concerning revenues and debt management. In order to pinpoint those concerns, I have sent a letter to Secretary Brady with a list of questions regarding the administration's proposal. A copy of that letter has been made available to all members, and I would like to include a copy in the record. It is my understanding that Secretary Brady will respond to that letter tomorrow in a separate submission to be included as part of this record.

[The letter and response follow:]

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COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
WASHINGTON, DC 20515

February 23, 1989

The Honorable Nicholas F. Brady
Secretary of the Treasury
U.S. Department of the Treasury
1500 Pennsylvania Avenue, N.W.
Room 3330
Washington, D.C. 20220

Dear Secretary Brady:

As you know, you are scheduled to testify on March 9 as part of the Committee on Ways and Means' hearings on the budget implications and current tax rules regarding troubled savings and loan institutions, as well as the President's fiscal year 1990 budget. I am very pleased that you will have the opportunity to present the Administration's proposals to the Committee.

In order to facilitate your testimony and the Committee's review of the savings and loan institution issues, I request that your testimony address the following questions. I understand that the Administration's specific legislative proposals to assist troubled savings and loan institutions were introduced in the Senate yesterday, however, I have not had the opportunity to review them. Thus, it would be of great assistance to this Committee if you would address the following questions which relate to the Committee's jurisdiction over issues involving revenues and management of the debt.

1. Does the Administration's proposal to assist troubled savings and loan institutions (hereafter "Proposal") provide for a legal commitment of the Federal government to pay the principal or interest on any bonds issued by the Resolution Financing Corporation (REFCORP)?

2. Does the Proposal contemplate an indirect or moral obligation of the Federal government to pay, or otherwise financially indemnify, the payment of principal or interest on bonds issued by REFCORP? In this regard, what representations will be made to potential purchasers of these bonds?

3. Under the Proposal, do you anticipate that the Resolution Trust Corporation (RTC) will have the ability to require institutions insured by the Federal Savings and Loan Insurance Corporation (FSLIC) or the Federal Deposit Insurance Corporation (FDIC) to pay increased premiums or other assessments? If so, to what extent is the RTC anticipated to exercise this authority?

4. What is the total amount of premium payments you anticipate being paid by institutions insured by the FSLIC during the first five years after the implementation of the Proposal?

   (a) How much of this amount is a result of increasing the premium payments required of institutions insured by the FSLIC under the Proposal?

   (b) What is the total amount you anticipate will be expended from the FSLIC insurance fund during the first five years after implementation of the Proposal?

   (c) For what purposes will these amounts be expended?

   (d) What is the total amount you anticipate to be available in the FSLIC insurance fund at a time five years after the implementation of the Proposal? Please provide an estimate of the ratio of insurance fund reserves to insured deposits after that five year period.

5. With respect to question 4, please provide the same information with respect to institutions insured by the FDIC and the FDIC insurance fund.

6. If the RTC does exercise its authority as discussed in question 3, please provide, if applicable, the same information requested in question 4 with respect to premium payments and assessments made by the RTC.

7. What other sources of funds, besides those which may be specified in questions 4-6, will be used to make interest payments on REFCORP bonds?

8. What will be the sources of funds to be used by REFCORP to purchase the zero coupon Treasury securities under the Proposal?

9. Do you anticipate that through legislation, ruling, or informal administrative activity, REFCORP will be considered exempt from Federal taxation?

10. With respect to question 9, please specify the anticipated tax treatment to REFCORP resulting from its holding of zero coupon Treasury securities under the Proposal.

11. Please specify whether the Financing Corporation (FICO) established by the Competitive Equality Banking Act of 1987 is treated as an entity exempt from Federal taxation.

12. Please describe the anticipated tax treatment of the bonds to be issued by REFCORP.

13. Under the Proposal, how are funds raised by REFCORP paid to troubled thrift institutions?

14. Does the Administration propose and support an extension of the special tax rules for troubled thrifts and banks, currently expiring on December 31, 1989? Why are these expiring provisions important in providing assistance to troubled institutions? If so, will such an extension be included as part of the Proposal? What would be the revenue effect of any proposed extension, and how should any revenue loss be paid for?

    I want to emphasize, Mr. Secretary, my position that if the Administration supports extension of these expiring tax provisions, such a proposed extension should be included in the Administration's official savings and loan proposal rather than in separate legislation later in the year that may or may not materialize.

I look forward to receiving your testimony on March 9, and to working with you as a resolution of this issue is formulated. Thank you for your attention to this request.

Sincerely yours,

Dan Rostenkowski

Dan Rostenkowski
Chairman

DEPARTMENT OF THE TREASURY
WASHINGTON

ASSISTANT SECRETARY

March 16, 1989

Dear Mr. Chairman:

Enclosed please find the Department of the Treasury's response to questions on savings and loan institutions issues as requested by the Committee on Ways and Means in your letter of February 23, 1989.

Sincerely,

John Meagher
John K. Meagher
Assistant Secretary
(Legislative Affairs)

The Honorable Dan Rostenkowski
Chairman
Committee on Ways and Means
House of Representatives
Washington, DC 20515

Enclosure

cc: The Honorable Bill Archer

Question #1:

Does the Administration's proposal to assist troubled savings and loan institutions provide for a legal commitment of the Federal Government to pay the principal or interest on any bonds issued by REFCORP?

Answer:

- The principal of all REFCORP bonds would be paid entirely by the S&L industry itself. No Treasury funds or guarantees are involved in any way.
  - FHLBank retained earnings and profits, S&L premiums, and the proceeds from old FSLIC receiverships would be used to purchase zero coupon Treasury securities.
  - At maturity, the zeroes would be used to pay off the principal of the REFCORP bonds.
- The interest on REFCORP bonds would be paid by the S&L industry with the Treasury making up any shortfall.
  - Contributions from FHLBank profits, the Resolution Trust Corporation's proceeds from the sale of receivership assets, and proceeds from warrants and equity participations taken in resolutions will be contributed from the industry.

Question #2:

Does the Proposal contemplate an indirect or moral obligation of the Federal government to pay, or otherwise financially indemnify, the payment of principal or interest on bonds issued by REFCORP? In this regard, what representations will be made to potential purchasers of these bonds?

Answer:

- There are no hidden Federal government obligations in this plan whatsoever.
  - The $50 billion principal on the bonds will be guaranteed by zero-coupon Treasury bonds purchased by the industry itself. There is no set of circumstances under which Treasury funds would be used to pay any of the REFCORP bond principal.
  - The U.S. Treasury will make the interest payments on the REFCORP bonds, but will pay only the shortfall after industry contributions to interest payments are exhausted.

- By being as forthcoming as possible with our legislative proposal and Congressional testimony, we believe that we have already made this representation to potential purchasers of these bonds.

Question #3:

Under the Proposal, do you anticipate that the RTC will have the ability to require institutions insured by the FSLIC or the FDIC to pay increased premiums or other assessments? If so, to what extent is the RTC anticipated to exercise this authority?

Answer:

- The RTC has no authority to assess institutions and is funded entirely from the proceeds of REFCORP bond issues.
- The Resolution Funding Corporation (REFCORP), with the approval of the Board of Directors of the FDIC, may use insurance assessments to fund zero coupon Treasury securities only if the FHLBank contributions are exhausted.
    - The amount of these assessments (plus FICO assessments) is subtracted from the amount the FDIC is authorized to assess insured savings associations.
    - Thus, the authorized assessment limit for the FDIC is an absolute limit. REFCORP has no power to override this limit.

Question #4:

What is the total amount of premium payments you anticipate being paid by institutions insured by the FSLIC during the first five years after the implementation of the Proposal?

Answer:

- Between 1989 and 1993, FSLIC-insured institutions will pay $13.1 billion in insurance premiums.
    - Of this amount, $.9 billion will be the result of our proposed 2.2 basis point increase in the insurance premium in 1991, 1992, and 1993. The premium will decrease by 5 basis points in 1994.
- All of the funds collected in insurance premiums will be expended.

- -- About $1 billion per year will be required to cover the interest on the $10.8 billion in FICO bonds.
- -- The remaining premium income in 1990 and 1991 will be used to fund the REFCORP principal and the FSLIC Resolution Fund (for old FSLIC assets and liabilities).
- -- Beginning in 1992, premiums go first to service FICO interest and then to build up the Savings Association Insurance Fund (SAIF).

o We anticipate that in 1993 the SAIF could have as much as $8 billion in it, depending on the amount needed to resolve insolvent institutions after the RTC has closed the 500 institutions that are either GAAP insolvent or nearly GAAP insolvent.

- -- In any case, under our plan, the Treasury would guarantee that at a minimum the SAIF would have $2.1 billion in it by 1993.

Question #5:

With respect to question 4, please provide the same information with respect to institutions insured by the FDIC and the FDIC insurance fund.

Answer:

o Between 1989 and 1993, banks will pay $15.8 billion in insurance premiums.

- -- Of this amount, $5.9 billion will be the result of our proposal for increased premiums.

o No bank premium funds will be spent on FSLIC-insured institutions.

- -- We have recommended this premium increase to bring the bank insurance fund back up to its historical level.
- -- The bank fund is currently at $14 billion, which is .83% of insured deposits. We expect it to reach 1.25% sometime after 1999.

Question #6:

If the RTC does exercise its authority as discussed in question 3, please provide, if applicable, the same information requested in question 4 with respect to premium payments and assessments made by the RTC.

Answer: (see question #4)

- Our plan assumes that REFCORP may require some premium income to fund the REFCORP principal.
  - Before the use of premium income, $2.7 billion in FHLBank retained earnings and profits will fund REFCORP principal from 1989 to 1991.
  - If interest rates are consistent with OMB assumptions, $1.7 billion of premium income will be required for this purpose in both 1990 and 1991. If interest rates are higher, a smaller amount of premium income will be required.
  - Again, neither RTC nor REFCORP has any authority to increase premiums above the FDIC assessments.

Question #7:

What other sources of funds, besides those which may be specified in questions 4-6, will be used to make interest payments on REFCORP bonds?

Answer:

- No S&L insurance premiums will go towards the payment of interest on REFCORP bonds. However, other sources of industry funds will be used towards interest payments.
  - Proceeds from the sale of new receivership assets, proceeds from warrants and equity participation taken in resolutions, and $300 million per year in FHLBank profits will be contributed from the industry, and proceeds of all net assets of the RTC upon its dissolution.
  - Treasury funds will make up any shortfall in interest payments.

Question #8:

What will be the sources of funds to be used by REFCORP to purchase the zero coupon Treasury securities under the Proposal?

Answer:

- No Treasury funds or guarantees will be used to repay any REFCORP principal.

- All funds for repaying REFCORP principal will come from the industry itself.
  - FHLBank retained earnings, and as required, S&L premiums and proceeds from the sale of old FSLIC receivership assets will fund the principal.

Question #9:

Do you anticipate that through legislation, ruling, or informal administrative activity, REFCORP will be considered exempt from Federal taxation?

Answer:

- In our proposal, REFCORP would be tax exempt in the same way that the Federal Home Loan Banks and FSLIC's Financing Corporation (FICO) are. FICO is owned by the FHLBanks, just as REFCORP would be.

Question #10:

With respect to question 9, please specify the anticipated tax treatment to REFCORP resulting from its holding of zero coupon Treasury securities under the Proposal.

Answer:

- In the Administration proposal, the zero coupon Treasury securities would be treated just as those held by FICO, which are tax exempt.
- If this were not the case, any funding proposal would have to be more expensive.
  - In fact, the effect would be felt in the first three years of our proposal, because more zeros would have to be purchased up front to fund the $50 billion in principal.

Question #11:

Please specify whether the FICO established by the Competitive Equality Banking Act of 1987 is treated as an entity exempt from Federal taxation.

Answer:

- Yes, the FICO established by the Competitive Equality Banking Act of 1987 is tax-exempt. It is treated just as its owners, the Federal Home Loan Banks, are treated.

resolutions.

Question #14:

Does the Administration propose and support an extension of the special tax rules for troubled thrifts and banks, currently expiring on December 31, 1989? Why are these expiring provisions important in providing assistance to troubled institutions? If so, will such an extension be included as part of the Proposal? What would be the revenue effect of any proposed extension, and how should any revenue loss be paid for?

Answer:

- The Administration plan does not include an extension of the special tax rules. We expect them to expire after December 31, 1989.
- These provisions were important to FSLIC resolutions quite simply because FSLIC did not have adequate resources to use cash to deal with the hundreds of insolvent thrifts.
- Our plan, however, provides what we believe will be more than enough funds up front to resolve all currently GAAP insolvent institutions, as well as any others that may become insolvent.
    - As a result, we do not anticipate that the RTC will need to use any special tax benefits.

Question #12:

Please describe the anticipated tax treatment of the bonds to be issued by REFCORP.

Answer:

- The Administration proposal would provide that the obligations of the REFCORP would have the same tax status as obligations of the FHLBanks. This is also true of FICO obligations.
    - Thus, interest earned on these obligations would be taxable as income at the federal, but not the State level.
    - Treating REFCORP and FICO obligations in the same manner as FHLBank obligations is derived from the fact that the FHLBanks are the owners of FICO and the proposed owners of REFCORP.

Question #13:

Under the Proposal, how are funds raised by REFCORP paid to troubled thrift institutions?

Answer:

- Funds raised by REFCORP would be provided to the Resolution Trust Corporation (RTC), in exchange for capital certificates in an equal amount.
- The RTC is authorized to enter into a contract with the FDIC (as primary manager), and any other entity to manage insolvent institutions.
    - Management of these institutions might involve placing them in receiverships, liquidating conservatorships, engaging in assisted mergers, or liquidations.
    - The RTC Oversight Board would consider all relevant proposals, including innovative new approaches forthcoming from public agencies and the private sector, in overseeing the RTC's resolution activities.
- The RTC Oversight Board, consisting of the Secretary of the Treasury, the Chairman of the Federal Reserve Board, and the Attorney General, is charged with general oversight of the strategy and execution of the resolution process. This involves determining resolution strategy and reviewing and approving

Chairman **Rostenkowski**. As I have stated before, it is certainly not my intention to delay the consideration of this important proposal. It is my hope that when this committee considers this legislation after the Banking Committee has acted, we will consider the appropriateness, including the cost effectiveness, of measures within our jurisdiction.

Today the committee will also continue to receive testimony regarding the tax policy aspects of mergers and acquisitions.

Our first witness is Secretary Brady. Good morning, Mr. Secretary. I am pleased that you can join us, but before you begin, I would like to yield to my colleague, Mr. Archer.

Mr. **Archer**. Thank you, Mr. Chairman, and thank you, Secretary Brady, for making yourself available to us this morning.

As we begin the third day of our committee's hearings on the budget and tax implications of the current situation in the thrift industry, I want to emphasize my view that it is essential that the Congress and the administration take action on the thrift problem as soon as possible.

I am very concerned by reports that indicate that each additional day that we wait costs us $40 million.

We are all grateful to President Bush for sending to the Congress a solution to the thrift problem within less than 3 weeks of taking office. The enormity of the President's task and Secretary Brady's task cannot be overstated. While the administration proposal may be changed in a number of ways before it is enacted, it provides a broad framework to guide the Congress in its deliberations.

The Bush proposal has brought much needed reassurance to depositors throughout the Nation, that their hard-earned deposits are protected. That is a point that we in Congress need to constantly emphasize in our public and private statements. We cannot let the message that deposits are protected get lost in the congressional debate over individual points in the proposal.

I believe that the other members of this committee share my desire to expedite any necessary action within the committee's jurisdiction, and I look forward to your testimony, Secretary Brady.

Chairman **Rostenkowski**. It is a pleasure, Mr. Secretary, to have you with us this morning. If you are ready, you may begin.

STATEMENT OF HON. NICHOLAS F. BRADY, SECRETARY, U.S. DEPARTMENT OF THE TREASURY, ACCOMPANIED BY DENNIS ROSS, ASSISTANT SECRETARY FOR TAX AFFAIRS

Secretary **Brady**. Thank you, Mr. Chairman, and as you mentioned, you asked the Department a detailed—to submit a detailed list of questions, and we are in the process of supplying the answers to those questions, and they should be up here today if they are not here already. So, that procedure is all right with you.

Chairman **Rostenkowski**. Thank you, Mr. Secretary.

Secretary **Brady**. A good part of my testimony you have heard before, Mr. Chairman, so I have picked parts of it out, and if it seems a little disjointed, it is just that I will not reread stuff that you have already heard before.

I am pleased to be here with you to discuss President Bush's proposed fiscal year 1990 budget and related items. I know you have already heard from the Office of Management and Budget Director, Dick Darman, so in my testimony, I will not repeat a detailed presentation of the Bush budget.

The approach to the budget I wish to take today is from the perspective of overall economic policy. Thus, I will discuss the importance of deficit reduction to the continued vitality and strength of our national economy and improving our position in the world economy.

We are all aware that we continue to be in a period of extraordinary economic expansion. At the same time, we are also aware that the Federal Reserve recently raised the discount rate one-half of 1 percent, to 7 percent. I would like to say a few words about that.

First and foremost, the administration and the Federal Reserve share absolutely a firm commitment to fighting inflation. It is possible, however, to have somewhat differing interpretations of the same economic statistics, to think one set of statistics means more than another, and still share the same goal of fighting inflation.

The Federal Reserve is using the strongest weapon in its arsenal to fight inflation to advance the cause of the long-term strength and vitality of the economy. The strongest weapon we in the Government have, both the executive and the legislative, to further the cause of our long-term economic strength, is to act on deficit reduction. I am sure you agree, we all must do our part.

The Bush administration is absolutely committed to working with you to reduce the deficit. Some have questioned our economic assumptions, but I would like to point out that historically, the executive branch's assumptions have not had a consistent bias toward a rosy scenario. In fact, in the last 7 years the administration underestimated growth four times and overestimated it three.

For this year, we believe that the economy will continue to grow, but at a slightly slower pace than last year's drought adjusted rate. We are projecting that GNP will grow 3.5 percent next year, but when we exclude the impact of the rebound from the drought, our forecast is for a moderate 2.8 percent growth rate. This is lower than last year's 3.4 percent drought adjusted growth rate, and our long-term forecast for a 3.2 percent sustainable growth rate is right in line with our experience over the past 40 years, during which real GNP averaged 3.3 percent.

As one who worked for over 30 years in the financial markets, I would like to make a few comments on interest rate assumptions. During my first year in business, 1954, 10-year Government bonds carried an interest rate of 2.4 percent. They reached 14 percent in 1981. These same 10-year Government bonds were 12.4 percent as recently as 1984, but declined to 7.7 percent in 1986, and they now carry an interest rate of about 9.3 percent.

I attach an exhibit which you may have seen before, but it shows a graph showing the decline in interest rates surrounding the passage of Gramm-Rudman. From 3½ months prior to the passage of this important fiscal legislation until 3½ months after, interest rates declined 300 basis points.

Was it the only cause of this rapid decline in interest rates? No. Was it a principal cause? Yes, I believe so.

This would indicate to me that while there is plenty of room for honest disagreement about the future level of interest rates, there is some evidence that fiscal actions have a direct effect on these rates, particularly long-term rates. My conclusion is that investors and savers all over the world are waiting for a sign from our Government that we are committed to fiscal prudence and are willing to do something about it. Delay in reaching a budget agreement may only maintain the current high level of interest rates and cost the United States and the world unnecessary pain.

In sum, do I think our economic assumptions will prove true if we do not reduce the deficit? No, I do not. Will they prove accurate if we do? Yes, I believe so.

I know that you have heard a great deal about the specific proposals in the budget from Director Darman. I would simply like to reiterate the fundamental point that within the confines of meeting the Gramm-Rudman, the President has proposed budget priorities, which if adopted, will make a significant investment in the country's future.

A few words about the savings and loan solution.

President Bush's budget contains the funding required to resolve the savings and loan crisis. It has three components. The first part consists of $50 billion to resolve currently insolvent institutions and those which may become insolvent over the next several years. Secondly, the plan ensures adequate servicing of the $40 billion in past FSLIC obligations. And third, and perhaps the most important, the plan provides $33 billion in financial resources necessary to put the S&L deposit insurance fund on a sound financial basis for the future.

At the heart of the plan is the creation of the Resolution Trust Company, so-called RTC, for which the FDIC will be the primary manager, directed to resolve all S&L's which are now insolvent or become so over the next 3 years.

To provide the $50 billion to the RTC, we will create a new, separate, privately-owned corporation—the Resolution Funding Corporation, so-called REFCORP—which will issue $50 billion in long-term bonds to raise the needed funds. To pay the principal, industry funds will be used to purchase zero-coupon, long-term Treasury securities which will grow through compound interest to a maturity value of $50 billion, the same amount of the REFCORP principal bonds. This assures the repayment of the principal bonds issued by REFCORP. Funds to purchase these zero-coupon bonds will come exclusively from private sources.

The Federal Home Loan Banks will contribute about $2 billion of their retained earnings, which are currently allocated to, but not needed by, the existing Financing Corporation—FICO—plus approximately 20 percent of their annual earnings, or $300 million in 1989, 1990, and 1991. The S&L's will contribute a portion of their insurance premiums, and, if necessary, proceeds from the sale of FSLIC receivership assets will be used.

No Treasury funds or guarantees will be used to repay any REFCORP principal. Interest payments on the REFCORP bonds will come from a combination of private and taxpayer sources.

The Federal Home Loan Banks, beginning in 1992, will contribute $300 million per year. The RTC will contribute a portion of the proceeds generated from the sale of receivership assets, and proceeds from warrants and equity participations in resolutions, and, if necessary, Treasury funds will make up any shortfall.

All Treasury funds planned to be used to service REFCORP interests will be scored for budget purposes in the year expended.

Funds for the second component of our plan, servicing the cost of $40 billion in resolutions already completed by FSLIC, also will come from a combination of S&L industry and taxpayer sources.

FICA will issue bonds under its remaining authority and contribute the proceeds. The S&L's will contribute a portion of their insurance premiums. FSLIC will contribute the proceeds realized from the sale of receivership assets taken in already completed resolutions, as well as miscellaneous income, and, again, Treasury funds will be used to make up any shortfall.

The final component of the plan is managing future S&L insolvencies, and building the savings association insurance fund, so-called SAIF, the new S&L insurance fund during the postwar period.

The funding will come from a portion of S&L insurance premiums and Treasury funds, as needed. These sources provide about $3 billion per year to handle any insolvencies which occur in the 1992–99 period, and, in addition, contribute at least $1 billion per year to the building of the new savings association insurance fund.

Overall, the plan contains $33 billion in post-RTC funds from 1992 to 1999, to manage future insolvencies, and contribute to building a healthy new S&L insurance fund. Assuming that $24 billion is used for post-RTC resolutions, by 1999, the SAIF fund will still contain just under $9 billion, at a minimum, to support the healthy S&L's.

The net impact of the entire plan, which includes paying for completed S&L resolutions, paying for the S&L resolutions still to be completed, and providing for fully funded insurance funds for both commercial banks and thrifts, is $1.9 billion in fiscal year 1990, and $39.9 billion over the next 10 years.

The President's budget includes important revenue-related measures that fall within the jurisdiction of the Treasury Department. These measures also directly reflect the President's commitment to a budget that sustains a strong economy and builds upon it to enhance our future economic power.

First of all, we propose a major tax initiative designed to enhance America's long-term growth and competitiveness, and a reduction in restructuring of the capital gains tax to encourage long-term investment.

Our proposal calls for a 45 percent exclusion of long-term gains, or a 15 percent tax rate cap, whichever benefits the taxpayer the most. As an important part of this plan we have targeted the greatest relative benefits to those with incomes lower than $20,000, if married, and $10,000, if single.

Such taxpayers would be eligible for 100 percent exclusion, and no tax at all on the long-term gains. The policy of a lower tax rate for capital gains was first established in the Revenue Act of 1921 and remained in effect for 65 years.

The Tax Reform Act of 1986 eliminated that differential in 1987, while generally reducing taxes. In our view, the reinstatement of some type of capital gains differential is consistent with one of the major goals of the 1986 act. That was, and is, to reduce tax rates to stimulate entrepreneurial activity. Our proposal does that by targeting the benefit of those activities which will expand economic productivity and expand investment.

I believe the essential benefit of a reduction of capital gains tax goes beyond simply encouraging short-term investment and growth. Over the next 4 years, we propose to phase in a 3-year holding period for capital assets sold to qualify for the lower capital gains tax rates.

Thus, we want to shift the focus of investors from short-term to the long-term because, ultimately, it is our long-term investment which will provide our economy with its fundamental strength. Thus, we propose to restore this incentive to the American enterprise system.

Enhancing incentives for long-term investment is not the only area in which we need to act if the United States is ~~going to~~ remain a leader in the world economy.

It is equally important that we take steps to augment policies and programs which stimulate research and development, and which foster our long-term productive capacity. To this end, the President's budget increases investment in basic research by increasing funding for science and technology programs by 13 percent over the enacted 1989 funding levels.

Furthermore, we propose to make the tax credit for research and experimentation permanent. For a number of years, we have had a temporary tax credit to encourage additional research and experimentation by U.S. industry.

The current credit expires at the end of 1989. We feel it is time to stop sending stop-and-go signals to the business community on the importance of research to our economic strength.

Accordingly, the President has proposed to make this credit a permanent feature of the landscape, so that U.S. corporations can make their research and experimentation plans for the longer horizon.

With this same purpose in mind, the President has also proposed a permanent and more beneficial formula for the allocation of R&E expenses between domestic and foreign income.

In order to stimulate local Government and private-sector revitalization of economically distressed areas, the President has proposed an enterprize zone initiative.

This initiative includes selective Federal employment and investment tax credits to be offered in conjunction with Federal, State, and local regulatory relief. Up to 70 zones may be selected between 1990 and 1993.

Mindful of the growing need for child care, the President proposes to increase assistance to low-income families through changes in the Tax Code. He proposes a new refundable tax credit of up to $1,000 for each child under 4 in low-income working families.

This credit would be available to very low-income families in which at least one parent works in the tax year 1990, and will be expanded to include additional families in following years.

By this tax assistance the President's budget provides vital support to families while permitting them to make their own choices about child care that best fits their needs.

The President further proposes to make the existing dependent care credit refundable. In its current state, the existing credit is of no value to low-income families who do not pay a tax.

The President also proposes to permit the deduction from income of expenses incurred associated with the adoption of special needs children, up to a maximum of $3,000 per child.

Currently, State and local employees hired prior to April 1986 are not covered by Medicare hospital insurance, nor are they subject to the tax. The President's budget proposes that as of October 1, 1989, all State and local Government employees would be covered by Medicare hospital insurance.

These are the major revenue-related proposals in the President's budget.

Let me say a few words about the international context of our discussions. Improving our competitive position in the world economy is very important to our future international economic position.

Reducing the deficit will not only improve our competitive position but is of vital importance to our overall international economic standing. I wish to take a few minutes to address the international implications of our work on the budget this year.

The new reality is that there are no more international boundaries when it comes to the flow of dollars. No border control, no Customs officials, and no barriers. The influence of foreign financial markets on our economy is great indeed.

Most of the world's dollar financial transactions settle daily through New York. Before the advent of instantaneous transfer of information and electronic funds transfer, this settling of accounts would have taken several weeks, if not months. Now it occurs every night.

There are two wires that go through the New York Fed where transactions settle. The CHIPS wire which largely handles international transactions, and the Fed wire which handles mostly, but not exclusively, domestic transactions.

Last month, on average, about $735 billion worth of transactions were settled per day on the CHIPS wire, and the level of activity is increasing at the rate of 25 percent a year.

If you approximate the international transactions settled via the Fed wire, then about $1 trillion of international transactions are settled every day and every night through these systems. This amounts to $5 trillion a week. In other words, greater each week than our yearly GNP.

Another statistic which demonstrates the power of international finance on our economy is that at the end of 1987, the recorded stock of U.S. assets held by foreigners was about $400 billion greater than the stock of foreign assets held by Americans.

While one can have different views of how to interpret these numbers, one point is clear. We cannot ignore the effect of international markets on our balance of payments when considering the need for deficit reduction.

Both the flow of financial transactions through the two Fed wires, and the amount of U.S. assets held by foreigners are, in a sense, a measure of foreign confidence in our ability to maintain a sound economy and reduce our budget deficit.

The tally of the world's opinion of our progress is registered every day at the New York Fed. It is vital that we act decisively to preserve that confidence.

Lest there be any doubt about the extent of the world's interests and concern about the deficit, let me share with you some of the feelings that the G–7 has, who met here in Washington just a few weeks ago on our economy, and what we are doing about the deficit. In the G–7 we are engaged in a team effort, the economic policy coordination process to provide a growing world economy.

For our part, I have been pressing our foreign colleagues to stimulate their domestic economies and open their markets to sustain world growth. They, in turn, are deeply concerned about our ability to reduce the deficit. They worry that we lack the strength of purpose to meet the Gramm-Rudman target.

And they are knowledgeable about the details of our budget process, and are watching very carefully how we handle our budget negotiations.

They are concerned that our commitment to abiding by the current Gramm-Rudman targets is less than firm and unequivocal. That if meeting the $100 billion target becomes too onerous, that we will simply move the goal line.

I assured them on behalf of all of us, that people in this Government, legislative and executive branches alike, are firmly and absolutely committed to meeting the deficit reduction target. I told them we would get there, one way or the other.

Mr. Chairman, I know you share this commitment, and I am delighted to be here today to discuss with you anything in my testimony, and anything we can do to achieve this common goal.

[The statement of Secretary Brady follows:]

Testimony by
Secretary of the Treasury
Nicholas F. Brady
Before the
Committee on Ways and Means
U.S. House of Representatives
Wednesday, March 15, 1989

Chairman Rostenkowski, Mr. Archer and members of the Committee, I am pleased to be here today to discuss with you President Bush's proposed fiscal year 1990 budget. I know that you have already heard from the Director of the Office of Management and Budget, Richard Darman, so in my testimony I will not repeat a detailed presentation of the Bush budget.

The approach to the budget I wish to take today is from the perspective of overall economic policy, thus, I will discuss the importance of deficit reduction to the continued vitality and strength of our national economy and to maintaining and improving our position in the world economy.

We are all aware that we continue to be in a period of extraordinary economic expansion, which has produced millions of jobs, while reducing inflation. We must equally be aware that to sustain this expansion we must reduce the deficit.

As you know, the Federal Reserve recently raised the discount rate one half of a percent to seven percent. I'd like to say a few words about that. First, and foremost, the Bush Administration and the Federal Reserve share absolutely a firm commitment to fighting inflation. It is possible to have somewhat differing interpretations of the same economic statistics, to think one set of statistics means more than another, and still share the same goal of fighting inflation.

The Federal Reserve is using the strongest weapon in its arsenal to fight inflation to advance the cause of the long-term strength and vitality of our national economy. The strongest weapon we in the government have to further the cause of our long-term economic strength is deficit reduction. We must do our part. Even to delay action costs us -- in terms of interest rates, jobs, the Savings and Loan crisis, the third world debt problem.

Let us be frank with one another. We are constrained between revenue levels that are the result of the 1988 election which validated President Bush's commitment to "No new taxes" and a Gramm-Rudman-Hollings maximum deficit level of $100 billion prescribed in law. So, there are not funds to do all that we want.

Stepping back from the roar of the budget discussions for a minute, one could say, "This is where the country wants us to operate." The key is to have the American people say, "They did what we wanted with what we gave them."

ECONOMIC ASSUMPTIONS

The Bush Administration is absolutely committed to working with you to reduce the deficit. Some have questioned our economic assumptions. But, I would like to point out that historically the executive branch's economic assumptions have not had a consistent bias toward a rosy scenario. In fact, in the last seven years, the Reagan Administration underestimated growth four times and overestimated it three.

For this year, we believe that the economy will continue to grow, but at a slightly slower pace than last year's drought adjusted rate. We are projecting that GNP will grow 3.5 percent next year. But when we exclude the impact of the rebound from the drought, our forecast is for a moderate 2.8 percent growth rate. This is slower than last year's 3.4 percent drought adjusted growth rate. Our long term forecast for a 3.2 percent sustainable growth rate is right in line with our experience over the past 40 years, during which real GNP growth averaged 3.3 percent.

As one who worked for over 30 years in financial markets, I would like to make a few comments on interest rate assumptions. During my first year in business, 1954, ten-year government bonds carried an interest rate of 2.4 percent. They reached 14 percent in 1981. These same ten-year government bonds were 12.4 percent as recently as 1984, but declined to 7.7 percent in 1986. They now carry an interest rate of about 9.3 percent.

Attached as an exhibit to my testimony is a graph showing the decline in rates surrounding the passage of Gramm-Rudman-Hollings. From three and one-half months prior to the passage of this all-important fiscal legislation until three and one-half months after, interest rates declined 300 basis points. Was it the only cause of this rapid decline in interest rates? No. Was it a principal cause? Yes.

This would indicate to me that while there is plenty of room for honest disagreement about the future level of interest rates, there is some evidence that fiscal actions have an effect on interest rates, particularly long-term rates. My conclusion is that investors and savers all over the world are waiting for a sign from our government that we are committed to fiscal prudence, and are willing to do something about it. Delay in reaching a budget agreement may only maintain the current high level of interest rates and cost the U.S. and the world unnecessary pain.

In sum, do I think our economic assumptions will prove true if we don't reduce the deficit? No. Will they prove accurate if we do? I believe so.

I know that you have heard a great deal about the specific proposals in our budget from Budget Director Darman. I would simply like to reiterate the fundamental point that, within the confines of meeting the Gramm-Rudman-Hollings target, the President has proposed budget priorities which if adopted will make a significant investment in our country's future.

THE SAVINGS AND LOAN SOLUTION

The President's budget contains the funding required to resolve the Savings and Loan crisis. It has three components. The first part consists of $50 billion to resolve currently insolvent institutions and those which may become insolvent over the next several years. Secondly, the plan ensures adequate servicing of the $40 billion in past FSLIC obligations.

And third, and perhaps most important, the plan provides $33 billion in financial resources necessary to put S&L deposit insurance on a sound financial basis for the future.

At the heart of our plan is the creation of a Resolution Trust Corporation (RTC), for which the FDIC will be the primary manager, directed to resolve all S&Ls which are now insolvent or become so over the next three years.

To provide the $50 billion to the RTC, we will create a new, separate, privately-owned corporation, the Resolution Funding Corporation (REFCORP), which will issue $50 billion in long-term bonds to raise the needed funds. To pay the principal, industry funds will be used to purchase zero-coupon, long-term Treasury securities which will grow through compound interest to a maturity value of $50 billion. This assures the repayment of the principal of the bonds issued by REFCORP. Funds to purchase these zero-coupon bonds will come exclusively from private sources:

-- The FHLBanks will contribute about $2 billion of their retained earnings -- which are currently allocated to, but not needed by, the existing Financing Corporation (FICO) -- plus approximately 20 percent of their annual earnings, or $300 million, in 1989, 1990 and 1991;

-- The S&Ls will contribute a portion of their insurance premiums; and

-- If necessary, proceeds from the sale of FSLIC receivership assets will be used.

No Treasury funds or guarantees will be used to repay any REFCORP principal.

Interest payments on the REFCORP bonds will come from a combination of private and taxpayer sources:

-- The FHLBanks, beginning in 1992, will contribute $300 million a year;

-- The RTC will contribute a portion of the proceeds generated from the sale of receivership assets, and proceeds from warrants and equity participations taken in resolutions; and

-- Treasury funds will make up any shortfall.

All Treasury funds used to service REFCORP interest will be scored for budget purposes in the year expended.

Funds for the second component of our plan -- servicing the cost of the $40 billion in resolutions already completed by FSLIC -- also will come from a combination of S&L industry and taxpayer sources:

-- FICO will issue bonds under its remaining authority and contribute the proceeds;

-- The S&Ls will contribute a portion of their insurance premiums;

-- FSLIC will contribute the proceeds realized from the sale of receivership assets taken in already completed resolutions, as well as miscellaneous income; and

-- Treasury funds will be used to make up any shortfall.

The final component of the plan is managing future S&L insolvencies and building the Savings Association Insurance Fund (SAIF), the new S&L insurance fund, during the post-RTC period. The funding will come from a portion of S&Ls' insurance premiums and Treasury funds as needed.

These sources provide about $3 billion per year to handle any insolvencies which occur in the 1992-99 period and in addition contribute at least $1 billion per year to building the new Savings Association Insurance Fund. Overall the plan contains $33 billion in post-RTC funds from 1992 to 1999 to manage future insolvencies and contribute to building a healthy new S&L insurance fund. Assuming that $24 billion is used for post-RTC resolutions, by 1999 the SAIF fund will still contain just under $9 billion at a minimum to support the healthy S&Ls.

The net impact of the entire plan -- which includes paying for completed S&L resolutions, paying for the S&L resolutions still to be completed, and providing for fully funded insurance funds for both commercial banks and thrifts -- is $1.9 billion in FY90 and $39.9 billion over the next 10 years.

REVENUE PROVISIONS

The President's budget includes important revenue-related measures that fall within the jurisdiction of the Treasury Department. These measures also directly reflect the President's commitment to a budget that sustains a strong economy and builds upon it to enhance our future economic power.

CAPITAL GAINS

We propose a major tax initiative designed to enhance America's long-term growth and competitiveness: a reduction and restructuring of the capital gains tax to encourage long-term investment. Our proposal calls for a 45 percent exclusion of long-term gains or a 15 percent tax rate cap, whichever is more advantageous to the taxpayer. As an important part of this plan, we have targeted the greatest relative benefits to those with incomes lower than $20,000, if married, and $10,000 if single. Such taxpayers would be eligible for a 100 percent exclusion--no tax at all on long-term capital gains.

The policy of a lower tax rate for capital gains was first established in the Revenue Act of 1921. This policy remained in effect for 65 years. During this time it was endorsed by Democrats and Republicans alike as an important means of stimulating investment. The Tax Reform Act of 1986 eliminated that differential in 1987 while generally reducing taxes. In our view, the reinstatement of some type of capital gains differential is totally consistent with one of the major goals of the 1986 Act. That was, and is, to reduce tax rates to stimulate entrepreneurial activity.

Our proposal does that by targetting the benefits of those activities which will expand economic productivity and expand investment. I believe the essential benefit of a reduction in the capital gains tax goes beyond simply encouraging short-term investment and growth. Over the next four years, we propose to phase in a three-year holding period for capital assets sold to qualify for the lower capital gains tax rates. Thus we want to shift the focus of investors from the short-term to the long-term, because ultimately, it is long-term investment which will provide our economy with its fundamental strength. Thus we propose to restore this long-acknowledged incentive to American enterprise.

RESEARCH AND EXPERIMENTATION

Enhancing incentives for long-term investment is not the only area in which we need to act if the United States is going to remain a leader in the world economy. It is equally important that we take steps to augment policies and programs which stimulate research and development and which foster our long-term productive capacity.

To this end, the President's budget increases investment in basic research by increasing funding for science and technology programs by 13 percent over the enacted 1989 funding levels. Furthermore, we propose to make the tax credit for research and experimentation permanent. For a number of years, we have had a temporary tax credit to encourage additional research and experimentation (R&E) by U.S. industry. The current credit expires at the end of 1989. It's time we stopped sending stop and go signals to the business community on the importance of research to our economic strength.

Accordingly, the President has proposed to make this credit a permanent feature of the landscape so that U.S. corporations can make their R&E plans with a longer horizon. With this same purpose in mind, the President has also proposed a permanent and more beneficial formula for the allocation of R&E expenses between domestic and foreign income.

ENTERPRISE ZONES

In order to stimulate local government and private sector revitalization of economically distressed areas, the President has proposed an enterprise zone initiative. This initiative includes selected federal employment and investment tax credits to be offered in conjunction with federal, state, and local regulatory relief. Up to 70 zones may be selected between 1990 and 1993.

CHILD CARE

Mindful of the growing need for child care, the President proposes to increase assistance to low-income families through changes in the tax code. He proposes a new, refundable tax credit of up to $1,000 for each child under four in low-income working families. This credit would be available to very low-income families, in which at least one parent works, in tax year 1990, and will be expanded to include additional families in following years. By this tax assistance the President's budget provides vital support to families while permitting them to make their own choices about child care that best fits their needs. The President further proposes to make the existing dependent care credit refundable. In its current state the existing credit is of no value to lower income families who do not pay tax.

SPECIAL NEEDS ADOPTION

The President proposes to permit the deduction from income of expenses incurred associated with the adoption of special needs children up to a maximum of $3,000 per child.

MEDICARE HOSPITAL INSURANCE

Currently, State and local employees hired prior to April 1, 1986, are not covered by Medicare Hospital Insurance, nor are they subject to the tax. The President's budget proposes that as of October 1, 1989, all state and local government employees would be covered by Medicare Hospital Insurance.

These are the major revenue-related proposals in the President's budget. Let me reiterate that the intent behind these proposals is to sustain a strong economy while fostering an equitable distribution of benefits and responsibilities to our citizens.

INTERNATIONAL CONTEXT

Improving our competitive position in the world economy is very important to our future international economic position. Reducing the deficit will not only improve our competitive position, but is of vital importance to our overall international economic standing. I wish to take a few minutes to address the international implications of our work on the budget this year.

The new reality is that there are no more international boundaries when it comes to the flow of dollars--no border control, no customs officials and no barriers. The influence of foreign financial markets on our economy is great and deep. Most of the world's dollar financial transactions settle daily through

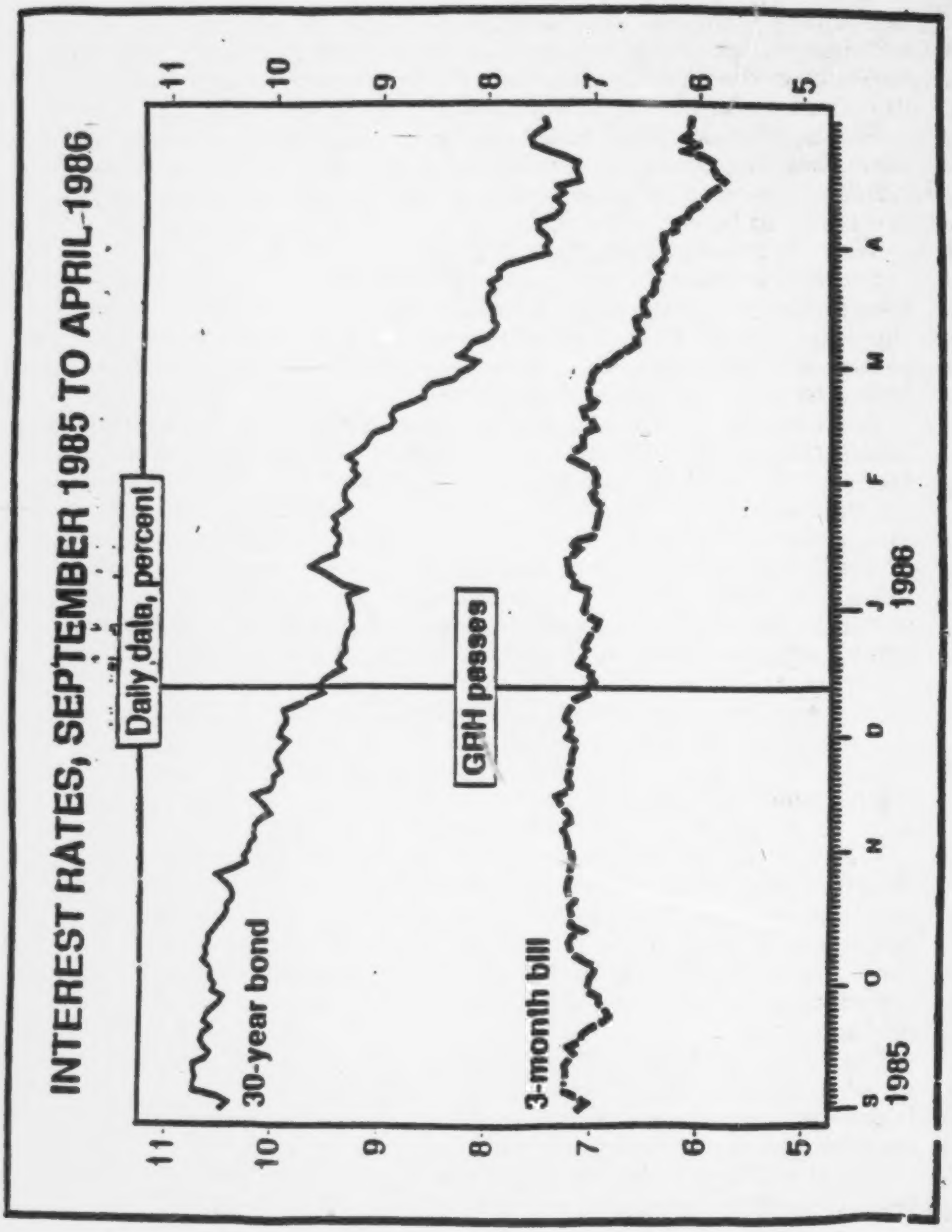
New York. Before the advent of instantaneous transfer of information and electronic funds transfers this settling of accounts would have taken weeks, now it occurs every night. There are two "wires" through which the transactions settle. The CHIPS wire which largely handles international transactions, and the Fed wire which handles mostly, but not exclusively, domestic transactions. Last month on average about $735 billion worth of transactions were settled per day on the CHIPS wire. And the level of activity is increasing on average at a rate of 25 percent a year. If you approximate the international transactions settled via the Fed wire, then about $1 trillion of international transactions are settled every day on these wire systems. This amounts to $5 trillion a week, in other words greater each week than our yearly GNP.

Another statistic which demonstrates the power of international finance on our economy is that at the end of 1987 the recorded stock of U.S. assets held by foreigners was almost $400 billion greater than the stock of foreign assets held by Americans. Ten years ago this difference was $50 billion in our favor. While one can have different views of how to interpret those numbers, one point is clear -- we cannot ignore the effect of international markets on our balance of payments when considering the need for deficit reduction.

Both the flow of financial transactions through the Fed wire and CHIPS and the amount of U.S. assets held by foreigners are in a sense a measure of foreign confidence in our ability to maintain a sound economy and reduce our budget deficit. The tally of the world's opinion of our progress is registered every day through CHIPS and the Fed wire. It is vital that we act decisively to preserve that confidence.

Lest there be any doubt about the extent of the world's interest and concern about the deficit, let me share with you some of the feelings of my G-7 colleagues -- who met here in Washington, DC the first week in February. We are engaged in a team effort, the economic policy coordination process, to provide a growing world economy. I have been pressing them to stimulate their domestic economies and open their markets to sustain world economic growth. They, in turn, are deeply concerned about our ability to reduce the deficit. They worry that we lack the strength of purpose to meet the Gramm-Rudman-Hollings target. They are knowledgeable about the details of our budget process and are watching very carefully how we handle our budget negotiations. They are concerned that our commitment to abiding by the current Gramm-Rudman targets is less than firm and unequivocal, that if meeting the $100 billion target becomes too onerous, we will move the goal line. I assured them on behalf of us all that people in this government--executive and legislative branches alike--are firmly and absolutely committed to meeting the deficit reduction target. I have told them that we will get there one way or the other.

I know you share this commitment. I am delighted to be here today to discuss with you how we can achieve this common goal.



INTEREST RATES, SEPTEMBER 1985 TO APRIL 1986

Chairman **Rostenkowski**. Well, thank you, Mr. Secretary.

Mr. Secretary, now that the administration has submitted a comprehensive proposal to assist troubled thrift institutions, does the administration have an opinion regarding the appropriateness of extending the special tax benefit rules assisting troubled thrifts and banks, which are scheduled to expire at the end of this year?

Mr. Secretary, there have also been some suggestions from members that we consider accelerating the expiration of those provisions to the date of enactment of the assistance proposal that we are going to be considering.

What is the administration's position on that?

Secretary **Brady**. First of all, Mr. Chairman, the administration's position is that with regard to the existing legislation which allows these initiatives to expire at the end of the year—these provisions in the law—that we do not tamper with the law, and they be allowed to expire at the end of the year.

With regard to the suggestion that if the S&L legislation is enacted, that we terminate those benefits, while we have not studied that, we think that proposal has merit and is worthy of real study.

Chairman **Rostenkowski**. We have received, Mr. Secretary, much testimony regarding whether the entire savings and loan bailout program should be on budget.

Do you agree, first of all, that the overall costs of the program would be lowered using an on-budget approach, and would you consider such a revision in the administration's proposal?

Secretary **Brady**. Mr. Chairman, my feeling is that we have a plan here that will work. The discussion that is centered about whether the cost will be higher, or lower, is focused on whether the REFCORP interest is more expensive than straight Treasury bonds, and our estimate has been that that would be the case, perhaps to the extent of 25 basis points.

We have made the point, at the same time, that the savings and loan industry contributes $300 billion a year to the REFCORP interest payments. That $300 billion divided by the $50 billion principal amount is 60 basis points. So, from our point of view, we feel that the contribution of the industry overshadows the—60 basis points is greater than the 25 basis points that it will cost us to go off budget.

But going on from that technical point, I know there has been a lot of discussion about other plans, and other ways of going at this. I can only say that there is a lot of compromise, and a lot of give and take in the legislation as we have put it forward.

For the 2½ months, or 3 months that we worked with the industry, with the regulatory authorities, with Congress, and with people in the executive branch, there was a lot of pulling and hauling as to what should go where.

I can only say to you that this plan, which has the backing of the banking industry, not the complete backing of the S&L industry but the attitude from the more responsible parts of it, that this makes sense, is an attempt to take the energy and effort of all of the people that have been involved in this problem and move the ball forward.

So there may be other plans, and we would be glad to look at them, but it is a question of what those other plans would produce in the way of reaction to Congress, and slow the advent of this bill being signed and put into law. So there may be other plans. I would not deny that, but I would more than welcome any attempt by anyone else to come up with one.

I just would reiterate that there is a lot of energy in this one. There are some imperfections in it, but I think we have corralled everybody who has got any input into this problem and kind of moved it towards the finish line.

Chairman ROSTENKOWSKI. Well, Mr. Secretary, I do not intend in any way to delay the action on this legislation. I know how important it is that we accelerate it. But we have had testimony that we could save $100 million to $300 million a year if the plan was on budget, and I just wondered whether you had any comment on that?

Secretary BRADY. Well, Mr. Chairman, I am not trying to be captious, but I cannot comment on that outside the parameters of seeing a whole plan. I mean, if we did it some other way, would the S&L industry be up here complaining to such an extent? Would the banking industry be up here complaining to such an extent that we did not get anywhere?

I can only say to you, that if there is some other plan we would be glad to look at it, but this—and I do not want to be boring on this subject—but this has got a lot of energy behind it, not just Treasury energy, but industry energy, and congressional energy, and it is a plan 330 pages long, with testimony out of the OMB that is so complicated nobody can understand it. And I just would submit that this is the best we can do. There may be some other ways to look at it.

Chairman ROSTENKOWSKI. Thank you, Mr. Secretary. Mr. Archer.

Mr. ARCHER. Mr. Secretary, thank you, again, for coming before us this morning.

I think you would agree with me that the Federal Government will never permit its guarantees of deposit to go into default. The President has said that a number of times, and I think the American people should be certain that we will not fail in securing these deposits.

And yet in spite of that, we have seen a $10.7 billion withdrawal of savings from the S&L's in January, and I wonder if you would like to comment on that.

Secretary BRADY. Congressman, I am glad you brought this point up. First of all, I know everybody on the committee, and certainly everybody in the administration, wants to assure anybody that has got a deposit which carries a Federal guarantee, that that money is good.

That it should not be confused, the discussion—the necessary discussion we are having over this item should not be confused with the absolute total commitment of both the executive and legislative branch to pay those deposits off.

Now, with regard to the outflow of funds, some $10 billion in January, in one sense it surprises me that it was not bigger. Every nightly news program, every front page of every business section, every business magazine, has got, in black headlines, the $90 billion, the $50 billion hole in the savings and loan industry. You can imagine what effect that would have on a person who is not as well versed as all of we are in the intricacies of the Federal Deposit Insurance.

The effect it would have on somebody in Smalltown, America. All he sees is the morning and evening news saying S&L bailout, or S&L problem, $90 billion. He says, "Well, my gosh, I've got my money in the S&L. I'm going to take it out."

I am convinced that as soon as we can go through the deliberate and necessary questions and answers that go to considering this bill, as soon as we have got the Congress's imprimatur on some legislation, and the President signs it, we will go back to business as usual, because the S&L industry is a very vital part of this country, and it is necessary, people want it, they are in every small town in the United States, and I think you will see this flow stop as soon as we get the bill through Congress.

Mr. **ARCHER**. I thank you, Mr. Secretary, and I can say that it is clear to me that there is a strong bipartisan agreement in the Congress to move effectively and rapidly on this issue, and that the public should be certain that these deposits will be protected.

Chairman **ROSTENKOWSKI**. Mr. Gibbons will inquire.

Mr. **GIBBONS**. First, Mr. Secretary, I want to commend you and your colleague, Secretary Bennett, for the courageous and correct action you took yesterday on automatic weapons, or semiautomatic assault weapons.

We have a bill very similar to that, that is moving through the subcommittee right now. We may have some legislation for you to strengthen your hand as you go along.

Mr. Secretary, I have no objection to your plan to rescue the depositors in the S&L's with a minor exception—and it is not minor with me, it is major with me—I just do not think we ought to pass this interest cost off on the generations that are yet unborn, and I, frankly, do not intend to support that part of the legislation.

I think that we can solve it much better with some kind of surcharge, or a surtax, and pay for it. It is our generation's problem. We created the mess and we ought to straighten it out. We should not pass that on to my children and my grandchildren.

What is your response to that?

Secretary **BRADY**. Well, Congressman, obviously there are different ways of looking at this problem. I must say that there are a lot of things we do, as I view the budget proceedings, where we are passing the cost forward, and I think that although your point is extremely well-taken, the system that we have come up with is one that tries to pay for this over a period of time, and get the industry to go along with it as best we can. We may have a slight difference of opinion.

Mr. **GIBBONS**. Well, it is not slight, Mr. Secretary. You take $50 billion and you compound the interest on it, and it has doubled its size in 8 years, and it has doubled its size again in 16 years, and, you know, we are talking about $200 billion to $400 billion now of interest that is going to have to be paid on all of this. That is not small in my book.

I have seen the interest costs of this Government go from very minor figures in just 8 years to $180 billion a year, which was more than the entire Federal budget when I came here, and I just am not going to go any further.

I realize that under Gramm-Rudman we are going to run up another couple of hundred billion, maybe $300 billion, $400 billion worth of interest, but I cannot see adding a whole brandnew program, Mr. Secretary. I think that would do more to destabilize the money markets around the world than anything else.

It would seem we would really strengthen the money markets, and we would reduce the interest rates if we would just go ahead and do something on a current basis, particularly a mistake like this which is uniquely our own, a governmental mistake, an institutional mistake.

You know, I am not going to support the part of the program that calls for borrowing money.

Secretary BRADY. Well, Congressman, I can only offer as the other side of the argument, that from what I hear from people who are involved around the world in other finance ministries, the thing that they have their eye on is the Gramm-Rudman target of a $100 billion, and my feeling on this may be the fact that I am a prisoner of talking to these people——

Mr. ARCHER. Mr. Secretary, that is just a camouflage job. You know they are smart enough to see through that. That is all it is, a massive camouflage job of another part of the debt. That is all it is.

Chairman ROSTENKOWSKI. Mr. Pickle will inquire.

Mr. PICKLE. Thank you, Mr. Chairman. Mr. Secretary, it is good to have you before the committee.

Let me make one or two observations first. I want to commend you for your recommendations on the research and development aspect, and to make that incentive permanent. We need that for competitiveness on both a national and international basis. So I commend you for that.

Secondly, I want to make the observation that whatever plan we approach, if you go the REFCORP route on the S&L bill, I want to warn you, or ask you to be mighty careful that whatever we do will not result in dumping properties all across the country.

Now, Mr. Seidman, some 10 days ago, testified that he was going to get a couple of evaluations and appraisals, and he was going to sell that property.

Now when he does that, if he does it—and he said it as bluntly—that means dumping to me, and if you do that, you are just going to wash my State right out in the Gulf of Mexico. So I am just saying to you, whatever the approach, we have got to guard against that because that will cause a great more trouble than we do otherwise.

Secretary BRADY. Congressman, could I just reply to that point because it is very important. I agree with you. I think that particularly with regard to your State, the RTC, which will have these properties inside it, probably has common ground with States like Texas in making sure that that dumping does not take place, because if you dump it you obviously get a lower price, and if the RTC dumps it, that means the cost to the Government has got to go up.

And obviously, with regard to Texas real estate, that is bad as well. So I think we have got common ground there, and that is not our intention. I hope that does not happen.

Mr. PICKLE. Well, I am encouraged that you would say that. I will also say to you that—in line with Mr. Rostenkowski's and Mr. Gibbons' position—would you consider something on budget?

I am a third member of the committee who would like to look at that approach, to see if we could do it. It would save the Government a lot of money in the long-run. But whether we can come up with that, that would be for us to discuss with you, and I think we should do that.

Now, in the area of capital gains, your administration estimates you would have a gain of about $9 billion over a period of some 6 years. The Joint Tax Committee said you would lose $24 billion over the same period. Now as one who generally favors capital gains, lowering it, I must say to you I do not think this committee is going to take any action as long as we cannot get those figures adjusted. You simply cannot approach or make a decision when you have two estimates: a plus of 9 and a loss of 24. If you expect to advance that, I must say to you that you have to come nearer on these figures.

Now in your plan that you recommended, you said that if you included commercial real estate in your capital gains plan, that would lead to tax sheltering, so you exclude that.

Now, if you did that, it seems to me like you have really done damage to the long-term depreciable property.

Why did you exclude the long-term depreciable asset?

Secretary BRADY. Congressman, we felt that that area of the economy already had certain tax advantages in the fact that they could write off certain—take certain writeoffs with respect to buildings and properties of that nature.

So, we felt that the incentives in that area were enough, and that they in effect—we did not want to get back into trying to justify what some people call tax loopholes.

Mr. PICKLE. Well, Mr. Secretary, in the 1986 bill, we enacted the passive loss provision, we toughtened the minimum tax, we lengthened the depreciation period, and we put limits on the deductibility of interest.

You pretty much have got safeguards against tax sheltering. Now to just automatically exclude depreciable property I do not think is an appropriate approach.

Can you tell me what your gain would be, or your loss would be—however you want to term it—if you did include depreciable property? Your estimate now of $9 billion, what would it be if you did include that?

Secretary BRADY. I do not have that figure with me, Congressman. I could provide it for you and I would be——

Mr. PICKLE. Well, I would ask one of your staff.

Secretary BRADY. I am told the figure is $7 billion over the budget period which is——

Mr. PICKLE. I did not hear you. How much?

Secretary BRADY. $7 billion over the budget period of 4 or 5 years.

Mr. PICKLE. In other words, it would be $9 billion plus the $7 billion?

Secretary BRADY. Yes.

Mr. PICKLE. Yes. So it would be a total of $16 billion in general.

Secretary **Brady**. No. Subtract it from.

Mr. **Pickle**. Oh, I see. All right. The other way around. Well, I want you to submit those figures to this committee because I think it is terribly important.

[The information of Secretary Brady follows:]

The total revenue effect of the administration's capital gain proposal over the budget period (fiscal years 1989 through 1994) is $9.3 billion. As shown in Table 2 of the Treasury Department's General Explanation of the President's Budget Proposals, the effect of excluding depreciable and depletable assets and collectibles over the same period is to add $9.1 billion. Thus, restoring these assets to the base eligible for the lower rate would reduce the $9.3 billion to $0.2 billion over the budget period. The $0.2 billion would increase slightly after taking account of interaction with the 3 year holding period requirement, which becomes effective for transactions starting in calendar year 1983. (Collectibles represent a negligible portion of the total added back to eligible assets.)—*Office of Tax Policy, April 26, 1989*

Mr. **Pickle**. My time is about up, but I will say to you again: you have got to get these estimated figures closer together. Here is the Joint Tax Committee, which is an impartial group, which has nothing to gain politically, which did not run for office, or make any promises about no taxes, and they are saying you are going to lose $24 billion.

I want to help, but I cannot do it when there is that much disparity.

And one last question—I want you to give it to me, if you cannot do it now—and that is in the area of passive losses in the tax bill of 1986. Cash out-of-pocket expenses, where, if you were in the rental real-estate business, and you were an active participant, and you were substantially involved in it, were denied to the extent they exceeded rental income.

Now it seems to me like that is not fair, and I think in 1986, the members on this committee—on this side of the Capitol—would have given relief in that area because it is very unfair. You cannot even take out of pocket expenses that have actually been paid.

I want to get your recommendation on if we can make some change on that, and if it would not make a big difference in the budget. I would hope you would all give some consideration to it, because it is terribly unfair.

Secretary **Brady**. We will look into it, Congressman.

[The following was subsequently received:]

The passive loss rules of section 469 generally disallow losses, including out-of-pocket losses, from a passive activity. It is not true, however, at least for individuals with moderate incomes, that the passive loss rules disallow all losses of active participants in rental businesses. Under section 469(i), individuals may deduct up to $25,000 of losses from rental real estate activities in which they actively participate. Because this provision was not intended to apply to high-income individuals, the allowable loss is reduced for individuals whose adjusted gross income exceeds $100,000 and is not available to individuals with adjusted gross incomes of $150,000 or more.

We believe that the out-of-pocket loss from an activity may bear no relationship to the real economic income or loss from the activity, and that the allowance of out-of-pocket losses from a passive activity is, thus, inconsistent with two of the fundamental premises of section 469. First, Congress determined that, in the case of a passive activity, only real economic losses should be allowed to offset nonpassive income. Accordingly, expenses from a passive activity (including out-of-pocket expenses) are allowed to offset nonpassive income only to the extent they exceed income from the activity, including income attributable to appreciation of the activity's assets. Second, Congress also determined that the existence and amount of a taxpayer's real economic losses from a passive activity should be ascertained only when there is a complete disposition of the taxpayer's interest in the activity. Thus, tax losses from the activity (including out-of-pocket losses) are suspended until the offset or until the disposition occurs. In effect, the passive loss rules provide that an out-of-pocket loss from a passive activity is not a real economic loss that is recognized for tax purposes if it is recouped out of subsequent income from the activity or gain on its disposition.

The passive loss rules may be less accurate than a system in which economic income or loss is measured on an annual basis. Under such a system, out-of-pocket expenses would be deductible, except to the extent they were required to be capitalized. On the other hand, the measurement of economic income or loss on an annual basis would necessitate a mark-to-market rule under which unrealized appreciation of assets during a year is included in that year's income. Consequently, in many cases in which a taxpayer is out of pocket, the taxpayer's expenses for the year would be more than offset by unrealized appreciation in the activity's assets.

We view the passive loss rules, which disallow certain losses but do not require the recognition of unrealized appreciation, as a reasonably accurate approximation of economic income or loss. Thus, we do not believe that the disallowance of out-of-pocket losses from passive activities is unfair. In any event, the measurement of real economic income or loss on an annual basis was rejected for reasons that include the practical difficulties involved and the desire to retain the availability of certain tax preferences in appropriate cases. We are not aware of any change in circumstances that would justify the reconsideration of this decision.

The allowance of out-of-pocket losses, without offset for unrealized appreciation, would have a significant effect on revenues. Moreover, the indirect effeets of such a change could be even more significant. The passive loss rules are only one of the many base-broadening provisions contained in the Tax Reform Act of 1986. We are concerned that the allowance of noneconomic losses under section 469 may lead to requests for similar relief by taxpayers adversely affected by other base-broadening provisions and that the untimate result of such a change might be the reversal of a substantial portion of the 1986 reforms.

Secretary Brady. Could I just reply for about one second to the important question you have raised on the revenue estimates, the Treasury estimates being different than the CBO estimates.

I must admit, as a newcomer to this process, I am as mystified as anybody else as to why these estimates are so far apart. I can only tell you with regard—and I do not know the process that is used by the CBO. I can tell you about the process in the Treasury.

I do not know any of the estimates personally, and that is by design, because I think what we ought to have is, not having the Secretary coming up with ideas and then trying to tell the estimators how they want to have it come out.

So, when we try some of these various plans that have—various ideas that have wound up in our capital, in our revenue suggestions, we hand them over to the estimators to see what they are going to make of them. I do not know who these people are, men and women are.

I just want to assure you there is nobody beating them over the head trying to get them to go one way or the other. That is what they produce, and I am as mystified as the next guy as to why it is different.

Mr. Pickle. Well, I agree with you, Mr. Secretary, except I think you would agree that we must get those figures more in line with what we think are the facts.

Chairman Rostenkowski. Mr. Schulze will inquire.

Mr. Schulze. Thank you, Mr. Chairman. Mr. Secretary, I join the chairman and others in welcoming you to the committee. It is a pleasure to have you here.

First of all, in line with the relief to the savings and loan situation, when you were discussing options, did you look at all at the utilization of passive losses for distressed properties?

All of the people I have talked to—both in the business and in the industry, mortgage bankers, and others—seem to think that we could get a bigger bang for the buck by the proper utilization of passive losses in narrow usages.

So I guess my question basically is, during the discussion of options, and when you were working on the proposal, was this one of those items discussed?

Secretary BRADY. Congressman, my recollection of the exact details of every option is a little hazy.

As I remember, we did think about that, and our conclusion was that although it was a good idea, that it did not make that much difference, but we can take another look at it and get back to you.

Mr. SCHULZE. I wish you would.

[The information of Secretary Brady follows:]

Yes, we did consider such a proposal; however, we determined that it did not make sense to include it. Providing selective relief from the passive loss would probably be quite complex, and we believe that as a matter of tax policy it was better to not follow that approach in structuring our savings and loan proposal.

Mr. SCHULZE. I have talked to Joint Committee, and I sort of sense a little bias against restoring passive losses. Let us forget that bias. If we get the biggest bang for the buck, and I have gotten some figures that it could dramatically help the situation in the Southwest and other areas, we would utilize fewer taxpayers' dollars in the long run. So I would hope that you would take a look at that.

Mr. Secretary, in regard to capital gains and capital gains on housing, as you know under current law there is a $125,000 forgiveness if a taxpayer of 55, or older, sells his home.

If we take the example of an individual or a couple, let us say, who sold their home for $325,000, the exclusion amount is $125,000 and the recognized gain is $200,000, would the $200,000 recognized gain be subject to the 45-percent exclusion, or would the full amount of the $325,000 be taxable?

Secretary BRADY. If you would permit me, I would like to ask Dennis Ross who is Assistant Secretary for Tax Affairs.

Mr. ROSS. Mr. Schulze, it would only be the $200,000.

Mr. SCHULZE. The gain.

Mr. ROSS. The $125,000 exclusion would be retained.

Mr. SCHULZE. OK. I have, as perhaps you know, a proposal which would totally eliminate capital gain on the sale of a principal residence.

It seems to me that if we are looking for simplification, this idea eliminates all of the recordkeeping that we are forced to do in rollovers over the years, and it eliminates also that incentive to buy up as you go along.

I know that you do not have a revenue figure on the top of your head, but if you have time, some time, I would be interested. I have gotten various estimates, some as low as between $300 and $400 million a year. If we do end up with a figure in that area, it seems to me the simplification is probably worth $300 to $400 million a year, not to mention what we would do for senior citizens. So if you have an opportunity, I would hope that you would look into that.

But before we get off the rollover situation, how would you treat—maybe Dennis would want to answer this one, too—how would you treat a partial rollover, where you sold the principal residence—again in a senior citizen type buy-down by going to a smaller place—and only took a portion of that as capital gain. How would the exclusion work?

Secretary BRADY. Congressman, could I just answer, and then Dennis can pitch in if you would like.

Our position at this point is that although we think there is great merit in the ideas that you have put forward, that the benefits we already give taxpayers for rollover in their principal residences—basically that there is no tax involved, if they are reinvested in a residence of greater value—is a pretty darn good break. And also as you have mentioned, we give a break to senior citizens, even more further along than that.

I think that your suggestions are very good ones, but in an era of budget stringency, are ones that we feel really should take a little bit further study, but they are very good ideas.

Mr. SCHULZE. Thank you. Maybe Dennis wants to address that.

Mr. ROSS. Mr. Schulze, in the partial rollover situation to the extent—because of only the partial rollover you recognize gain—the exclusion would be available, so——

Mr. SCHULZE. OK. One other question. Under your capital gains proposal, if you have a depreciable asset but you opt not to depreciate it, would it then be available for the favorable treatment?

Secretary BRADY. To be perfectly honest with you, I would like to get back to you on that.

My understanding is that the election is not at the taxpayers' hands, but perhaps in the writing of the law, there has been some change.

[The following was subsequently received:]

No. The proposal excludes property of a character subject to depreciation; thus, a taxpayer would not have such an option.

Mr. SCHULZE. If we implement such a proposal, should we consider making the optional depreciation part of it.

Secretary BRADY. Well, what we were really aiming at here was something in addition to capital gains—just the pure advantage that you would give somebody, and incentives we would give somebody—is to try and stretch out the investment horizons of people in the United States.

What we thought would be appropriate in that regard is the 3-year time period, which ought to be phased in over time in order to let people get accustomed to that.

We thought that there was, again, more bang for the buck in terms of trying to stretch out people's investment horizons, and therefore, stretch out the investment horizons of managers of businesses, if we focus that on the sales of stocks and the like, rather than buildings and that sort of thing. So we had kind of a little bit of a different agenda than just the one that you have suggested, Congressman.

Mr. SCHULZE. Thank you, Mr. Secretary.

Chairman ROSTENKOWSKI. Mr. Jenkins will inquire.

Mr. JENKINS. Thank you, Mr. Chairman. Thank you, Mr. Secretary, for your testimony.

Let me follow up just a moment as a supporter of the differential in capital gains through the years. I do have some problem with the distinctions that have been made.

You indicated to Mr. Pickle, I believe, that part of the difference, maybe in the revenue estimates, had to do with—I am assuming that there would be a churning effect as far as stocks are concerned?

Would there be an incentive to get out of the short-term into the longer-term——

Secretary BRADY. Would there be a churning effect? Well, I think the long-term effect would be less churning. In other words, the people would make investments for the long-term, that they—you know, the time horizon that we now have for capital for people who are making investment decisions is as long as it takes to make the profit.

A fellow buys a stock for $15 and it goes to $60. Ten minutes later, he is gone. That is his investment horizon. So the import of this plan is to try in over time—not right away, not tomorrow—to give a benefit to those people who are willing to lock up their savings for 3 years.

It seems to us they would do that based on examining the plans of the corporation in which they were about to invest, and they would want to make sure that this corporation had plans that they could stick with, because they get more of a profit in that particular regard. So I think the long-run effect will be less churning.

Mr. JENKINS. Well, I was trying to determine the disparity between the figures that we have. One is showing a net gain for the Treasury, and the other indicating that we would have a loss to the Treasury.

Secretary BRADY. I cannot give you the exact difference for that reason, for that result, Congressman. I can only say that among the fraternity of revenue estimators, it is our understanding that our revenue estimators are in the middle of the range of assumptions that determines how fast that things will turnover, and the CBO estimators who are at the end—you know, the other end in the framework.

But that would be something. You would have to get them both in the same room and see what they come out with. I think that their assumptions are different than ours, and we think that we are in the middle of the spectrum. We think that they are over on one side—the pessimistic side of the spectrum, but they might feel the same way about us.

Mr. JENKINS. Someone on your staff indicated that if we included depreciable property, we would lose some $7 billion, I believe, in revenues.

Why is it that we would lose revenues on depreciable property, and we would not lose money on stocks and bonds?

Mr. ROSS. Mr. Jenkins, our analysis shows—and I think the Joint Committee may agree with us on this. I am not certain.

But our analysis shows, in any event, that the depreciable assets, or the sale of the depreciable assets, are less sensitive to changes in the capital gain rate and assets such as corporate stock.

Mr. JENKINS. I do not know that I follow that.

Mr. Ross. Business circumstances, cycle of replacement, and a variety of nontax considerations are more likely to determine when a depreciable asset is sold, than in the case of pure investment assets, such as corporate stock.

Mr. Jenkins. So the Tax Code would have more influence upon stocks than it would upon depreciable property?

Mr. Ross. The tax rate on the gain would have more influence, yes.

Mr. Jenkins. I am trying to make the distinction now between depreciable property that loses money if you get a lower rate, and stocks and bonds suddenly gain money with a lower rate. It is still difficult for me to follow, to rationalize, between the two.

I would like to pursue that with you, and maybe you can convince me.

Secretary Brady. Why do we not have a private discussion on it. If you would like, Congressman, we can get into it.

Mr. Jenkins. I would like——

Mr. Pickle. If the gentlemen would yield, I would like some figures on that, as to your reasoning and how you estimate. I would be glad to talk to you personally, but I would like to see what the facts are.

Secretary Brady. Congressman, why do I not ask Assistant Secretary Ross who has been involved in the details of that to answer the question for you.

Mr. Pickle. All right.

Mr. Jenkins. Let me ask a final question. I appreciate the indication of the great need that we have for the international financing market, and obviously, they are contributing a great deal right at the present time to our deficit problems by investing foreign markets.

Obviously, it would be better if we had a higher savings rate here, so we could finance our own deficit, if we have a deficit, which we do.

Outside of the capital gains differential proposal, is there anything being proposed that would give an incentive to private savings? Do you see anything on the horizon to encourage private savings?

Secretary Brady. Congressman, there has been a lot of discussion in this country as to what we can do, and we tried the IRA accounts some number of years ago, and of course, they were discontinued recently.

One of the arguments that was used when they were discontinued is that they were not really producing any more savings. They were just transferring savings from one place to another.

I think what we have is a problem in this country where we are consumption oriented, rather than savings oriented. We have tried to put in our suggestions here, our revenue suggestions, the capital gains incentive, which we think will produce the revenues that are set forth in this table.

Mr. Jenkins. Would we be better off, really, to have maybe an exclusion for any interest earned from any Federal taxation up to $7,500 or so a year to increase this private savings rather than——

Secretary Brady. I think there are a number of things that you could do. The Japanese are experts at it, but they generally go—

they do not worry as much as we do about whether certain parts of the investment spectrum are being aided or benefited.

So the answer is that if you did do this, you would have to go—changes in the revenue code, which would benefit those people that had the savings, and generally speaking, the people that have the savings are in the middle income and upper income classes, and then you get into the discussion as to whether they should be getting tax breaks, rather than focusing on whether they are going to produce the savings.

We could do it, but in this period where we have such a narrow pass to get through in order to reach the Gramm-Rudman targets, it is probably not worthwhile trying to put those proposals together at this time.

Chairman ROSTENKOWSKI. Mr. Downey will inquire.

Mr. DOWNEY. Thank you. Mr. Secretary, if I can just change the topic for a moment, and ask you about your international debt relief plan that you discussed the other day.

Can you give me some idea of what the incentives you have in mind for the banks to participate in this plan, and whether or not there will be any budgetary impact on these incentives this year?

Secretary BRADY. Mr. Downey, we have the—if I can take just a minute to talk about the debt plan?

Basically, what we did last Friday was to put forward some ideas of how we might change the approach to Third World debt. That fundamental change was aimed at a number of things, but perhaps the most important thing that was aimed at, was trying to reduce the level of debt, rather than have every negotiation wind up in addition to the level of debt.

So we said there are a number of things that you have to do in order to try and get that down. Two of them, I would say, in two respects, they will affect the banks.

One is, there are certain regulatory aspects of how banks account for losses that should be examined. We are not saying that anything should change, but that is an area that should be looked at.

The second area is the actual—and I do not want to get too detailed, but this is a detailed problem.

One of the things that stops more debt reduction from taking place is the so-called labor and sharing agreements in bank loan syndicates, whereby the bank syndicate says that if there is any money coming back from a country, that it has to be shared ratably with each member of the group. And one thought would be, "Gee, that sounds fair."

But the truth of the matter is that it stops any kind of commerce from taking place, because the process is so cumbersome. So we have said that we should have a look at that.

Now, I will stop in one second, but when we laid out the ideas behind this plan, what we were really saying to the world was, "Come see us."

We think that we ought to aim in a slightly different direction—in fact, not slightly. We ought to change our focus toward debt reduction and away from having every negotiation start out with great intentions but wind up adding to the total amount of debt we have in the world.

So, what we will have to—you know, this will involve talking to the members of the G–7, the World Bank, the IMF, the debtors, the creditors, the regulatory agencies, and the Federal Reserve. It is a composite process, and it is so complicated, I will only leave it at that.

Mr. DOWNEY. First of all, let me just say that I personally think that that is the right direction to move into debt relief. I think the former policy was tried and was not successful.

Can you give us any indication—I mean, I realize the complexity of it—do you anticipate that in this fiscal year there will be a revenue impact that you might be coming to this committee and saying—you know, change their bad debt reserve, or maybe we want to use a carrot and a stick approach to some of our U.S. banks with respect to whether or not they participate in this plan.

Because personally I believe that during the early eighties, these banks did very well with these foreign loans, and frankly, should be asked to belly up to the bar of sacrifice, at this point, and I would hope that—I guess I am kind of leading you down this path—I would hope that if you are going to come to us for some incentives, that any incentives that the taxpayer has to bear to bring these banks to the table, be done in a way that they are satisfied that the banks have done more.

Secretary BRADY. I think it is too early to answer that question. We do not have a plan now which includes such incentives, but if the very last part of getting the Third World debt situation resolved involved banks taking write-offs, then that is something we ought to look at.

But it is such a complex problem, Congressman, I think we have to wait for these individual negotiations to show where we are going.

Mr. DOWNEY. Can I ask you—and I realize it is far too complex for a 5-minute question and answer period to develop anything—Treasury Secretary Baker had in mind a more case-by-case approach to the problem.

Is there any thought on your part that maybe we should abandon this idea of case-by-case and look to more broad principles with respect to how we treat whole classes of debtors with respect to relief, rather than waiting for each crisis to develop, whether it is a gasoline crisis in Venezuela, the election of the Peronistas in Argentina where they are claiming in their campaigns that they are going to boycott their debt payments?

It would seem to me that maybe—clearly, we are not going to ignore case-by-case examples, but rather for our own purposes of analysis, that it might be better to establish some broad principles that people can understand, so we do not just continue to react to crisis.

Could you comment on that?

Secretary BRADY. Yes. I do not think we can abandon the case-by-case method, and I know you are not suggesting that. Because what happens is that the way these things take place is, first, the Mexicans come in, then the Venezuelans come in, then the Brazilians, then the Argentineans, then the Chileans, then the Costa Ricans.

It is a one-by-one process, and I think what we have done, Congressman, is to suggest the idea that let us stop thinking for the moment about negotiations where debtors and creditors get together and there is a gap to be filled.

In other words, we wind up saying, "OK, the answer to this is, we need $2 billion, because we want to keep the debtors in the position of paying principal and interest." The banking system in our country wants that.

What we are saying is, "Let us not set the process. Let us not set our thinking towards that. Let us try to set it over here, where the process itself is aimed at debt reductions."

So the banking system can enter into negotiations with the debtor nations and try to reduce the stock of debt. Maybe allow them to—and provide the debtor nations with some facility. I do not mean a grandiose facility, but some way of getting the money and organizing themselves, so they can think about debt reduction instead of adding to the stock of debt. So I think you have to do that.

It would be impossible to come up with a grandiose solution, because it would not fit the particular cases. I think we have to take the guy that is before us and deal with him, and see if we can reorient it this way, and then maybe the next fellow that comes in will say, "Hey, that was a pretty good idea. Let us try that again."

Chairman ROSTENKOWSKI. Mr. McGrath.

Mr. McGRATH. Thank you, Mr. Chairman, and thank you, Mr. Secretary.

In your testimony, you articulated the administration's position which is to allow some of the provisions in the S&L tax provisions to expire by the end of this year.

I am wondering since the R&D credit and the allocation of that credit, is fully funded in the budget, plus nine or ten other expiring provisions due to expire as of the 31st of this year—whether or not the administration's position would be to allow those to expire also? These are things like mortgage revenue bonds, small issue IDBs, targeted jobs tax credits, educational assistance tax credit, legal assistance—that are due to expire at the end of the year.

I am wondering whether or not the administration has a position on those at this point?

Secretary BRADY. Our position is that we are going to allow most of those to expire.

Mr. McGRATH. Thank you. Mr. Secretary, we had a private conversation on the S&L issue yesterday.

In regard to the S&L problem, we have had this problem going back perhaps 6 or 7 years.

In New York State we had this problem some years back, and some healthy S&L's and savings institutions came forward and with a handshake with the Federal Home Loan Bank and FSLIC and others, provided a phoenix for some of the distressed banks in our area.

The new S&L bailout plan takes a different tact, because it eliminates some of the provisions that were agreed upon some years back in terms of goodwill.

I am wondering whether or not we could grandfather some of the arrangements that were made in good faith, going back some years, so that we do not put these phoenix banks in the same position that we find some of these distressed banks that we have today.

Secretary BRADY. Congressman, we did talk about this yesterday, and since the time that you and I had the conversation, I found out that this is an item of discussion between the Treasury officials that are responsible for this legislation and the people that you are referring to.

So you have a good point. We are trying to see if we can make any accommodation there.

Mr. McGRATH. Thank you, sir. One further question, that concerns capital gains. I would like you to perhaps put yourself in the position of somebody who sits on this side of the table.

With all of the discussion regarding either the gain or loss in revenue on the capital gains proposal, if we would agree that there is a capital gain revenue loss, there has been some suggestion by members on this committee that to compensate for the revenue loss, we would increase the top marginal rate in order to compensate for that particular loss.

I am wondering, if you were on this side of the equation, which way you would lean in terms of what is best for our economic picture?

Secretary BRADY. Congressman, I am very mindful of one point. I am mindful of it, because Chairman Rostenkowski has made it very clear to me his feelings on this matter over time, that we made a deal in 1986, and this is not the time to undo that deal.

But the Treasury came at it from a different point of view. We came at it from the point of view of how can we possibly take a step toward getting people to think toward longer-term horizons, and not be a country which is involved in financial engineering by Wall Street and various takeover groups around the United States.

How do we do that? Well, we took one crack at it. It was to try and look at the ERISA laws and see if we can make a change in the interpretation of the ERISA laws, so that a guy did not have—that somebody running a major pension fund, did not have to sell his stock just because he wanted to make a quick buck, that he could rely on the long-term plans of management.

So working with the Labor Department, we got that changed, and I think anybody who now goes and asks for an interpretation of the ERISA laws will be told that you do not have to take the quick buck, that you can look at long-term.

And then we said, "Well, what about investment? This churning that everybody complains about on Wall Street?" And we hear it everywhere that, you know, "What is going on?" The churning that is going on has no bearing on what the real world inside of the United States is doing in terms of industrial activity.

So we said, "Let us try and give a benefit to those people who are willing to look long-term and willing to make investments based on management saying, 'We are going to do this and this over a period of time.'" So that those managements are in a better position to compete with the Japanese and the Germans and the Koreans.

We simply cannot compete with these people if our investment horizons are no longer than 10 minutes, or however long it takes the stock price to go up.

So, I was not trying to get into any argument with this committee, and particularly Chairman Rostenkowski, because I know that is not a very good idea, but I was saying, "Let us try and look at this a different way. Let us try to see if we can do some things which will get our investors in this country, and therefore our managers, and therefore our corporations, aimed at long-term plans."

Now, it is not perfect, but I think it is a very good and useful first step. I did not answer your question about 2833, but that was not part of our thinking. I can understand the rest, how it might be——

Mr. McGRATH. Thank you, Mr. Secretary.

Chairman ROSTENKOWSKI. Mr. Pease.

Mr. PEASE. Thank you, Mr. Chairman. Thank you, Mr. Secretary.

I guess I would like to make a comment and then ask you a question. Regarding deficit reduction, you said in your testimony that the strongest tool of the Federal Reserve for curbing inflation is to affect interest rates, and that the strongest tool of the administration and Congress is on the fiscal side, that is, deficit reduction.

I agree with you. I do think, however, that it is important if we have deficit reduction—and I think you would agree—that it be credible deficit reduction.

Chairman Rostenkowski today, as he has in the past, stated his belief that credible deficit reduction requires a balanced package of both revenue and spending cuts.

My concern is that without revenue in the picture, we will again, as we have in the last 3 or 4 years, resort to gimmicks, and blue smoke and mirrors, to reach the Gramm-Rudman targets.

You are aware of the controversy over taking the S&L bonds off budget, adding their part of the long-run cost. You talk about long-term interest costs, and that is a factor there. Mr. Gibbons is particularly concerned about that.

Surely, if we do not deal with revenue, the negotiators will go to $109.9 billion as the target, the maximum allowable differential allowed by the Gramm-Rudman law.

It seems to me that if we do this with gimmicks, and blue smoke and mirrors, stretching every single point, using the most rosy scenario, that we are not going to have a very credible deficit reduction plan.

I mean, if you ask people whether the odds are, at the end of this process, in September, that we will be over, or under $109 billion in actuality, for fiscal year 1990, that most people will say we are going to be over $109 billion.

And it would seem to me that considering the stakes involved, the Treasury and the administration would want to be as conservative as possible. It seems to me you are being as optimistic as possible.

Certainly, if it is not a credible package, as you point out in your testimony, your own economic assumptions are not likely to prove correct, especially in relation to interest rates, as the Federal Reserve will surely try to push interest rates up further, and that, not so incidentally, will cause you further problems in trying to deal with Third World debt.

Now I realize that you and the administration cannot change your public stance on revenue as part of the package as you go into negotiations, but I just have to say for the record that in my opinion, it is a very risky course that you are running.

Now I want to turn to savings and loans and ask you a question. One of the things that we ought to do—I hope you would agree—is not only take care of the current situation, which I think the administration is commendably trying to do, but also try to prevent recurrence in the future of the same sort of problems.

And it is easy now to say, well, we made a mistake this time, we did not regulate closely enough, we did not have enough auditors, and so on, but we will do that in the future. I am not so sure that that is reassuring.

One of the factors which has exacerbated and worsened the situation that we are now in is the brokering of jumbo CDs, in directing large sums of money to these troubled S&L's.

I am wondering if the Treasury has any position on the role of brokered jumbo CDs, and whether you have any recommendations or plans to try to curb them in any way in the future?

Secretary BRADY. Congressman Pease, the way we have dealt with that in our S&L plan is to leave that, or to place that, rather, responsibility with the FDIC when and if the legislation goes through.

So we think this is an area they should look at, and look at right away, and we would leave pursuit of that problem to them, because we think it is a moveable feast, and you do not want to put regulations in there which might work today but be a hindrance tomorrow.

Mr. PEASE. All right. Thank you. Just finally, as my time is about to expire, I want to correct a statement you made in response to Mr. Jenkins, and the availability of savings incentives for American individuals.

You talked about IRA's in the past tense, and said they were discontinued. Of course, as you know, the IRA is fully deductible, and still an option for the vast majority of American taxpayers.

Secretary BRADY. Yes.

Chairman ROSTENKOWSKI. Mr. Dorgan.

Mr. DORGAN. Thank you, Mr. Chairman. Mr. Secretary, let me preface this by saying I have great admiration for your record of service in the private and public sector.

I want to ask a couple of questions, again about deficits and the budget. You know, you face some skepticism here on Capitol Hill about the economic assumptions, and I would guess that you understand why that skepticism exists.

We look at the economic assumptions and see that, for example, in interest rates, you portray a downward trend in interest rates to 3 percent in 1993.

And then we raise our eyebrows and say, well, this looks like it is just another chapter from the same old book. And what you have said today—and I read it carefully and listened carefully—you said that interest rates will drop when the world sees that we are serious about reducing the deficit.

But in fact when the world sees the economic assumptions in the deficit you present, doesn't it see just exactly the opposite? That we are not serious; that this is another chapter in the same old approach. Use optimistic assumptions to portray a lower deficit.

I am wondering if this is not kind of a circular logic that does not go any place, and that interest rates have been rising recently because people understand that this is not a serious approach. When we get serious we will use very realistic assumptions.

We will use whatever is necessary on the revenue side, and the expenditure side, to reach the objective.

Secretary BRADY. Well, Congressman, first of all, I do not defend Gramm-Rudman as the be-all and end-all, but it is the sanity that we have in the system at this particular point in time.

So, aiming at that goal line I think convinces the rest of the world that at least we are headed in the right direction. And I do believe interest rates will come down, but the economic assumptions, to me, that we have included in the budget with regard to growth are—as I mentioned to you, the administration has underestimated four times in the last 7 years, and overestimated three. And the figures that we are including for this year are about the same as they have been, for average, over the last 40 years.

So I can see that the process is not perfect, but, to me, it is as—you know, people forecasting interest rates is, to me, kind of a game that is pretty hard to win. If people could do that, there would be an awful lot of rich people who would be gambling in the bond market.

I just do not think it is possible. So what I tried to say was look, interest rates, when I started in business was 2.5 percent. They went to 14. They came down to 7. They went back up to 9. Now I am not sure we are going to reach 3, but I think we can come an awful lot lower.

Mr. DORGAN. Yes, but just between you and me, these interest rates are awfully optimistic. I would guess if you and I, and a number of others were sitting around here trying to figure out what do we really think is going to happen here, you would not be predicting 3 percent interest rates in 1993.

Secretary BRADY. Well, I think if we can get some closure on a budget, agreed to by the President and Congress, that you are going to see a movement in interest rates which will take the—downward—which will take the focus of discussion away from whether these interest rate trends are wrong, or right. Now if we do not come to that, then I agree with you. I mean, that they are going to stay up until we do.

Mr. DORGAN. And the only point I was trying to make is that the prospect of that closure is a prospect that is not enhanced at all by overly optimistic assumptions. So I would agree with you: if we come to some closure on the deficit in a real way, likely you would see some impact on interest rates. But the interest rates you use in the assumptions themselves make the prospect of closure less likely.

That is the only point I was trying to make, and I wanted you to understand why there is this enormous skepticism with respect to these numbers.

We have been through 8 years of budgets that really have been gamed in dozens of different ways, to show things that are not exactly the case, in order to demonstrate to the public something is happening that really is not happening. So that is our skepticism.

Let me ask, very quickly, about savings and loans. I asked the Federal Home Loan Bank Board for some information about savings and loans' purchase of junk bonds, and the answer is, well, it is not very significant. I said can you send me a list of the 10 savings and loans that hold the largest portfolio of junk bonds in the country, and they have done that, and asked that I not make that public, and I shall not.

But I want to ask you: As I looked down the list, it was fascinating to see that one savings and loan, for example, has 34 percent of its assets in junk bonds.

Does that represent to you, as it does to me, some colossal failure some place in regulatory authority? Somebody apparent is not looking. Does that concern you?

Secretary **Brady**. Well, I do not know whether it is regulatory authority or not, but I agree with your conclusion. But I would say to you that perhaps if that savings and loan operator had more of his own money up ahead of the Federal guarantee, he would not take that kind of a risk, and that is just where this program is aimed.

In other words, make these fellows put up their own money before we let them use the Federal purse in order to attract deposits to allow them to go out and buy the junk bonds that you have alluded to.

I think that you will see a lot less of that if we can get this legislation through, Congressman Dorgan, and I agree with you—34 percent in junk bonds does not sound like financing the future home ownership of the United States, to me.

Mr. **Dorgan**. Especially if purchasing junk bonds which are, by definition, higher-risk instruments, by an institution who knows it is going to be bailed out by us, by the taxpayers. It seems to me that while we do not have a lot of them in that situation, it seems to me there is something wrong, some place, that we have to fix in the regulatory scheme of things.

Plus I accept the point you make legislatively, and think it is something we need to consider.

Mr. Secretary, thank you very much for your response.

Chairman **Rostenkowski**. Mr. Coyne.

Mr. **Coyne**. Thank you, Mr. Chairman.

Secretary Brady, I think most people agree that we ought to have an early resolution of the savings and loan problem, and we are told by the League of Savings Institutions, that if there is a premium rate, that as many as 70 savings and loans may go into the red, and I wonder what your assessment of that reading by them is.

Secretary **Brady**. Well, I cannot comment on the exact number, Congressman, because everybody has a different way of calculating that number, but I would just venture a more general point which is that any time you apply the heat to an industry, as we have during this legislation, you are going to get a lot of people on the other side saying we cannot live under this regime, it will not work, you will deplete the industry, and you are trying to drive us out of business.

I have somewhat of a tin ear for that, although I think a lot of their concern is well placed, because I lived through the securities industry when we went through this exact same kind of thing. They outlawed the fixed commission which provided an enormous source of revenue to us, and we said, well, if you are going to do that we are all going to go broke. We will not be able to last.

At the same time, we had a lot of back-office trouble in the industry, and six or seven of the biggest firms in the industry went out of business, and the profitable firms had to pick up the tab. This is exactly what is happening to this industry.

We said we did not do that. You know, why should we pay? We cannot stand it; we cannot afford it.

All I can tell you is that 15 years later, the industry is about 10 times as profitable as it was then. So the exact number I cannot comment on, but all in all the fact is I expect to see a healthy S&L industry out there in the future, and I think there are some corrections that are being made here. They are tough, but in the main, they will produce a stronger industry.

Mr. Coyne. Well, in the event that some number close to that, 65, 70, or whatever it might be, does occur, will that adversely affect the President's proposal?

Secretary Brady. I think the President's proposal is pretty conservative. We did so in terms of the resolutions, for two reasons. One, we did not want to be predictive about the level of interest rates. If they go up, the problem gets worse; if they go down, the problem gets better.

Nor could we exactly pinpoint the number of institutions that would be adversely affected. So, in trying to come up with a figure of $50 billion which is what REFCORP is organized to take care of in terms of resolutions, we looked at a figure of resolutions which produced $18 billion worth of losses.

Now we said to ourselves, well, those are the book losses. They are going to be worse than that. So let's double that to $36 billion. We just did not double it, but we analyzed each of the individual ones and came out with a figure, after saying 30 percent more here, 40 percent there, up and down, to $36 or $40 millions, and then we—$40 billion—and then we said, well, we need a cushion of $10 billion just to make sure that we—you know—we have some room in the process in case we are wrong.

So I think we have got enough wherewithal in the program to take care of the things that you ask us about.

Mr. Coyne. On another subject, in your testimony, you indicated that there would be an exclusion of capital gains tax for those who earn under $10,000 per year.

In your testimony, you indicate that there would be a 100 percent exclusion for them. Do you have any indication of the number of people who experience capital gains with incomes less than $10,000?

Secretary Brady. I cannot give you the number of people. What I can do is give you what the two—for once, the CBO and the Treasury estimators were pretty close.

The steady-state figure we have in the Treasury estimates is $300 million a year. That it would produce $300 million of revenue. And the CBO estimate I think levels out at $400 to $500 million. So they think we will be even more successful.

We came up with this idea of let's see what it produces, and that is what it produced, Congressman Coyne. Let me say that don't forget that this is not just securities; this also applies to home ownership, so that it could come from there.

I do not know. The revenue estimators—I thought if they came up with $10 million, or $20 million, or $30 million, it would be a joke, but once they came up with this kind of a figure, I said let's put it in there and see whether it is there, and let them get the benefit of it.

Mr. COYNE. Thank you very much.

Chairman ROSTENKOWSKI. Mr. Guarini.

Mr. GUARINI. Thank you, Mr. Chairman.

Mr. Secretary, you have been before many committees in both Houses. You have answered every imaginable question over the past month, and I want to congratulate you on the way you have handled yourself. You have done it at a time when the market has gone the other way from some of the basis assumptions that were made as interest rates have been going higher, there have been fears of inflation, and there have been many people who have been lowering their estimates of the 3.5 GNP estimate that has been made for our growth.

In fact I have seen many figures that have come down, not only 2.8, but to 2 percent, which would impact on the $82 billion that we are counting on growth in order to balance the budget, and which would be additional revenue.

And when we look at the S&L problem, and how we are going to solve it, the drought fears that we have, the nuclear waste disposal that we have not even winked at yet, and we know that is almost a $150 billion problem, and the Third World debt which, of course, there is nothing in our budget regarding that, and we know that we are going to have to face that—we have really many, many concerns as to whether or not we are going to face a Gramm-Rudman surprise on August 15 when we take our snapshot.

Our production is near capacity, our unemployment is high, and the fear of inflation is real. And of course we do not have any contingency to back us up, just in case the worst scenario comes out.

And in regard to the Third World debt, I wonder whether or not—and you will be sitting in on those meetings—there is going to be any synergism between the drug problem that we have, where we spend almost $200 billion a year for health services and law enforcement, and loss of capacity, and social services that we deliver, that this drug problem has cost us in America.

And it would be a very cheap quid pro quo if we could help forgive some of the debt to some of these Latin American countries, if they would stop the production of the marijuana and the cocaine, and the heroin, or whatever drugs are coming into this country.

I hope when you sit down with the Group of Seven, and you sit down with the Third World countries and discuss the debt, and the partial reduction of the debt, that the drug problem does come up, because I think it is one way that we can get some benefit from their cooperation.

And when we are talking about that, too, I do not think you are ever going to solve the Third World debt unless you really resolve some of the corruption problems that they have within their countries, because you can forgive the debt and end up right back where you were in the first instance, because of the enormous problem that lies there in regard to corruption in some of these very fragile democracies that we have there.

Let me ask you this. If you had, hypothetically, a choice between a Gramm-Rudman cut on defense, which would of course cut back on a lot of spending in defense factories, et cetera, and it would be taking a hard hit on defense, or pass a consumption tax on gasoline, which do you think would be in the best interests of our economy?

Secretary **Brady**. Congressman, I am on the President's negotiating committee where we are working with leaders in Congress now, and if you will permit me, I will keep my opinions to myself until we get through that process.

Mr. **Guarini**. You see, when I opened up, I said you have been before many committees, and you have become very wise in the course of your discussions on some of these points, and I respect that.

Let me ask you, on estate taxes, we have an enormous build-up of wealth in the United States. Nothing is said about more estate taxes. There are some people that have accumulated over $6 billion of wealth, more than any family could have. You know, that is creating a tremendous imbalance in our society, where you have a few families that can have $10 billion, $20 billion, $50 billion in the course of time. You know, when you start—the eighth wonder of the world is when you have interest that continues to run on many of these businesses and investments.

Is there any consideration that is being given in regard to addressing the problem of the huge wealth that has been built up within a few families in our Nation? Would there be a better distribution of the assets of our Nation amongst all our people instead of just a few families having enormous strength and wealth, and power?

Secretary **Brady**. Congressman, I can understand how this is a concern to a lot of people, but I guess my answer would be is, I do not know who is the judge as to who ought to be wealthy and who is not. Perhaps we ought to leave that to the system that we have got.

I think maybe the American people would be less happy if there was some force afoot that decided who is wealthy, and how wealthy you have to be before that organization comes in and says that is enough. So we think about it but we have not got it in any present plans.

Mr. **Guarini**. I imagine that sooner or later we will be giving a lot of consideration to it, because just perpetuating this enormous wealth in just a few families is a concentration of power and privilege that will have a great impact on our society.

But that is a matter of philosophy and perhaps——

Secretary **Brady**. I think so.

Mr. Guarini [continuing]. A problem that has to be addressed, because we have reduced our estate taxes considerably over the last 10 years.

Secretary Brady. Sure.

Mr. Guarini. All right. Thank you, sir.

Chairman Rostenkowski. Mr. Levin will inquire.

Mr. Levin. Thank you, Mr. Chairman. Welcome, Mr. Secretary. Just quickly on the world debt plan. I congratulate you for your initiative.

It was not at all clear that day, what the attitude of the President was. The press secretary, as you know, issued a statement.

I understand details are being worked out, but has the President agreed yet with the concept of a debt reduction effort, directly?

Secretary Brady. Congressman Levin, I do not really understand what the confusion was. I gave a speech last Friday which was general in nature, and he had signed off on that speech. But there was some confusion, so last night, he issued a statement which said, roughly, the President fully supports the concept and processes aimed at debt reduction and economic growth which were set forth by Secretary Brady's speech at the Bretton Woods committee.

So I think if there was confusion on that before, there is not any now.

Mr. Levin. So when Mr. Fitzwater said the President has not made any final judgments about a new policy, he was talking about the details, and not that there needs to be a new initiative?

Secretary Brady. You know, maybe the word "policy" was not the right word, but it was the details.

Mr. Levin. Good. On the capital gains, in your statement you say as an important part of this plan we have targeted the greatest relative benefits to those with incomes lower than $20,000, if married, and $10,000, if single.

The Joint Taxation Committee has put out its analysis, and I am not sure you have seen it yet or if you have had a chance to review it.

I think we need to debate this issue and I am anxious to participate in it. I just think it is important, at the same time, we not try to sell it for something it is not. The Joint Taxation Committee shows, in terms of the distribution of the aggregate tax change, that 1 percent would go to people with incomes of $20,000 or less.

One-tenth of 1 percent to those with less than $10,000, and nine-tenths of 1 percent with those between $10,000 and $20,000. So I do not really see how it is accurate, even as one is trying to sell a proposal, to say that it is an important part of the plan.

Secretary Brady. Well, Congressman, I am—well, maybe I am guilty of trying to sell something. I was about to say I am not trying to sell something. But perhaps that is not the case.

I was not trying to say, in any sense, that the total amount of dollars that would be realized if this plan were adopted would accrue to the people under $10,000. That is not true, with incomes under $10,000 or family incomes under $20,000.

We, in thinking about this plan, put it out to the estimators one day, and they came back with a figure that showed that it would at least give benefits to those people of $300 million a year, and then that figure was even increased by the—was it the CBO, or the—

Joint Committee. Excuse me. So I am not trying to sell anything, but I thought it was a terrific idea, that if we can start—and I cannot visualize exactly who these people are.

Somebody said, well, you know, what kind of money do people have in this level? And I started to think maybe a few shares of a mutual fund, certainly their homes and things like that, and if we can give them a 100-percent benefit then—we all talk about equity—that, to me, is a very good idea.

If I said the "major share," that is wrong wording. I cannot remember what I did say, but——

Mr. LEVIN. No, you said "an important part of the plan," and then you used the word, or whoever wrote this, "we have targeted the greatest relative benefits."

And it is true, but if $300 million goes to one income grouping, and 20 to 50 times goes to another, I think to call the former an important part of the plan is an overstatement.

Sixty percent of the aggregate tax change goes to families in an income class, $200,000 and above. That is what the Joint Taxation Committee report says.

Secretary BRADY. Yes. Well, I think that you have to look at it a little bit of a different way, too. Most of the tax being paid by the wealthier family here—I mean, this is a—it is a fact of the organization of where the ability to do this is, and the people in the middle and upper classes have the money, so they do pay the most tax.

But the biggest break is given to those in the lowest category. I thought it was a pretty good idea, to be honest with you, and if the words that are chosen there you think are not accurate, I would not argue about that.

I think it is a very, very good idea to give these people, whoever they are, whoever the estimators think they are, chances to be made the biggest benefactors, percentage-wise, if we do something in this area. You know, maybe the next time, the estimators, if something happens and we do adopt this, and it starts to work, we are putting money at that end of the income spectrum where we are trying to provide the most help.

I do not know. I mean, it just seemed to me like a good idea. I would be glad to say it is just a good idea, and not take the other words out.

Mr. LEVIN. Just when you say the biggest money goes to low income people, I just think it is important for everybody to understand that the biggest portion, by far, goes to the highest income——

Secretary BRADY. OK. Let me amend and say the biggest tax break.

Mr. LEVIN. Thank you.

Chairman ROSTENKOWSKI. Mr. Moody will inquire.

Mr. MOODY. Thank you. Mr. Secretary, we certainly enjoy working with you. I want to commend you for your initiatives on the debt, Third World debt, and of course for moving expeditiously on the FSLIC problem.

I would like to chat with you for a minute about the comparative disadvantage that S&L's may be at in the future relative to other depository institutions, namely, commercial banks.

Let's talk first, for a moment, about the sticker. As I am sure you are aware, a New York Times editorial of March 7 said that the Treasury Department first promised S&L's that they would have the same FDIC sticker on the door, that the banks would have since they are both going to be under FDIC.

In my State of Wisconsin, banks are already beginning to play up the fact there is going to be a difference between the FDIC and the FSLIC sticker. They are running ads in papers.

The savings and loans, which we all want to see preserved, feel that this sticker war may be a serious disadvantage for them.

Is this still an open question? Could they have the same sticker since they are both under FDIC?

Secretary Brady. Congressman Moody, what we have done is sort of passed this question forward. In a sense we have, take two and hit to right. It was a matter of intense discussion between the S&L and the banking industry. We think it is going to take some more time to resolve that. Whether people would be satisfied with a sticker that said FDIC on top of it, and then has FSLIC underneath it, or savings and loan, federally chartered savings and loan in one case, and a commercial bank in another—we are not quite sure, and we think that that is something that is best left to the two parties that are trying to figure this out.

And if it passes forward to the FDIC, my feeling is that it is going to get settled, although it is a matter of strong feeling. You have said it exactly right.

Mr. Moody. Right. Well, we both would agree—I hope—that there is no distinction between the degree of protection. The first $100,000 is going to be protected, whatever the sticker. We do not want a sticker to make it look like there is a difference in the degree of protection to the depositor? Is that a fair statement?

Secretary Brady. Good point.

Mr. Moody. And I think that is the key, whatever the sticker says—it should not be drawn it looks like the depositor is more protected under one or the other.

Secretary Brady. Right. Good point, and I think, you know, everybody ought to say that really almost at the beginning of any statement on the S&L, that the Federal guarantee is there and people do not have to worry about it.

Mr. Moody. Right. Now moving for a minute to the premium and the possible deductions from the Federal Home Loan Bank Board. If the FSLIC fund reserves drop below a certain level, my understanding is that the premiums would go up and the Home Bank Board would have to put in more capital.

Under fairly reasonable scenarios, this would raise the basis points for savings and loan premiums by 56 points. Instead of about a 20 basis point differential, savings and loans would pay premiums more than 40 basis points higher than banks.

This is going to put the two depository institutions on a severely unlevel playing field if we want them both to survive. In fact, some material I have indicates that a rise of 57 basis points, which is triple the increase that banks face, exceeds, in many cases, the earnings of even healthy thrifts.

I certainly do not think we want to have a premium outcome which leads to the liquidation of otherwise healthy and well-managed thrifts. The reason I raise this is that my State of Wisconsin has healthy, well-run, well-managed thrifts, They understand they are going to have to pay more. Their operating margins, Mr. Secretary, are in many cases healthy. But many would be wiped out by this kind of premium differential relative to the commercial banks.

I certainly think it would be appreciated if you could address this.

Secretary BRADY. Well, I think that the 35 basis points is the highest it ever gets to, but we do not really expect it to get there, and the Treasury is putting in $9 billion per year to try to alleviate this problem.

So I do not think it is ever going to get there. It is permissive in the legislation, and I just do not think we will ever get to that point.

Mr. MOODY. All right. I appreciate your comment. I hope you are right, but it obviously raises some real fears among the well-managed segments of the S&L industry.

I understand that bank system capital and earnings assessed would raise that 35 up further on. So, if I am wrong, I would appreciate your later written comment. But my understanding is it could rise by 56.8 or almost 57 basis points for thrifts relative to the 14.2 basis point rise for commercial banks. That 3 to 1 difference could be serious. Any written comment would be much appreciated.

Secretary BRADY. Why don't we get back to you in print? My understanding is a little different but it would be better to do it that way, if that is OK.

Mr. MOODY. Thank you very much.

[Secretary Brady's reply follows:]

Annual premiums paid by commercial banks and thrifts could not exceed 35 one-hundredths of one percent under the administration's bill, H.R. 1278. (Section 208(1)(E)).

Although we do not anticipate any need to raise premiums to that level, we believe some ceiling on assessment rates is necessary.

Pursuant to an amendment to H.R. 1278 by Representative Barnard, the ceiling now appears in section 208(1)(C)(iv)(II) for Bank Insurance Fund members and in section 208(1)(D)(iv)(II) for Savings Association Insurance Fund members.

The thrift reform bill passed by the Senate on April 19, 1989, S. 774, provides for an annual assessment ceiling of 30 one-hundredths of one percent. (Section 208(4)(E)(III)).

Mr. MOODY. Mr. Andrews.

Mr. ANDREWS. Thank you, Mr. Chairman. Mr. Secretary, I would like to ask you to go back to something you said to Mr. McGrath that I think was important. I could not agree with you more.

I really think what we must do in the next year to 18 months is work toward a strategy to make us more competitive in an international marketplace, and I think you were absolutely right on target in suggesting that some of the initiatives that I think you have come forward with thus far, puts us in that direction.

And one of those is certainly the capital gains tax. I am not a person that is simply opposed to lowering the capital gains, and I am most receptive to it. But I am somewhat perplexed, in looking back at the regs and the debate that went on when the Tax Code was reformed in 1986.

I was not here, I was not on the committee, but it is my understanding that one of the justifications for lowering those rates was to raise the capital gains tax.

Tell me what has changed. You said we are different now than we were then. We have got a different attitude now and we need to be more competitive, or we need to be competitive.

Secretary BRADY. Sir, I am not sure I quite get——

Mr. ANDREWS. Isn't that a little bit inconsistent, that in 1986, when we reform the Tax Code, one of the justifications for lowering the rates was to not keep the capital gains rate down there because we could pick up dollars that way. Wasn't that one of the arguments made by Treasury and the Reagan administration to justify lower rates?

Secretary BRADY. Well, Congressman, I was not here either, but the aim of our plan now is to create a differential so that we induce people to invest at longer term.

I fully take the point that there were different arguments in 1986 when we put in the tax act of that date, but in our view, the way we should be looking at it now is to try to create a differential for capital gains, and only make that available in the long-term, over a 3-year period, with the idea that we will get people in this country aimed at longer-term plans.

Now, in coming up with that idea, it was not looking backwards, and it may have some inconsistencies with the things that were said at that time. It was looking forward to be, start picking away at a problem of how do we get ourselves in the position to compete with others around the world who do think long-term?

I mean we are in an economic contest which will ultimately wind up—I am not trying to deliver a thesis on this—ultimately wind up in, if we do not watch it, a lower standard of living for our own people. So let's try and work at this problem as we can.

Mr. ANDREWS. I agree with you, and I do not want to belabor the point, but I do see some inconsistent arguments, that looking back at the record and reviewing the debate made primarily by the administration, by the Treasury Department in the Reagan administration, to justify those lower rates, and one of the rationales for doing what they did with capital gains and lowering the rates was to make us more competitive.

Let me just ask you to also address our savings rate. The Japanese save at a rate of about 23–24 percent; the West Europeans, what? 13–14 percent. Our rate of savings has been what, in the last 12 to 18 months? Under 3 percent?

Secretary BRADY. That is as accurate as I can give it to you.

Mr. ANDREWS. Mr. Secretary, if you could enumerate for us some of the specific things you think we must do, as a Nation, to turn this deplorable savings rate around and encourage savings.

Secretary BRADY. Well, Congressman, you have put your finger on what I think should be the focus of all of us in the next several years—is what do we do about our savings rate? Because if we do do something about it, then a lot of things will disappear which are now major concerns, such as the concern over foreign investment in the United States, and the like.

Also, the size of our deficit, which is big in terms of our savings, but with respect to the GNP is respectable with other economies around the world. So the way I think about it is that we are pretty well pinched right now in terms of—because of the budget, and so there is not too much we can do except a few things like the capital gains tax that we put forward here right now.

But we ought to turn to that as quick as we get some leeway, and try to maybe come up with some incentives.

Mr. ANDREWS. Well, what would they be?

Secretary BRADY. Well, I cannot give them to you this morning, because to be dead honest with you, we have not spent a lot of time trying to be specific. But what I am told—maybe you have a different view—is that this problem is part mechanical, in the sense that the tax law would affect it, but also is the frame of mind that we have in this country.

We are, let's face it, a "fly now, pay later" society, and the other societies around the world, for reasons that are not clear to me, are not. So I think the attack probably ought to come in two areas.

When we can afford it, the revenue code, and some way of changing people's minds about how they should spend their money. I do not have the answer to that. It is a very, very deep problem.

Mr. ANDREWS. Thank you, Mr. Secretary.

Chairman ROSTENKOWSKI. Mr. Brady, thank you very much for joining us this morning. We appreciate the thoughts that you have shared with us.

I would just like to conclude with one observation. For extending expiring tax provisions alone, many of which currently expire on the 31st day of 1989, Mr. Secretary, there is a cost of over $3 billion in fiscal year 1990. That is just an extension of the expiring provisions.

Now we are talking about how we are going to raise revenue, and what we are going to do, and I agree with the President—I would like to see a kinder and gentler America—but I think we have got to pay for it, Mr. Secretary.

And the problems that I see with the budget, as it has been presented, are similar to those that some of the members on this committee have alluded to.

I just do not know that we are going to be able to impress our friends throughout the world with respect to how we are going to attack this deficit, unless we seriously start talking about some revenues.

Now I know that that is not acceptable with this administration, but I am hoping that over a period of time there can be a meeting of the minds and that we can become very serious about just how we are going to attack the problem that is ours. It is not the President's. It is not mine. It is ours. And I want you to know that I appreciate the time that you have spent with us this morning. Thank you very much.

Secretary BRADY. Thank you, Mr. Chairman.

[Whereupon, at 12:12 p.m., the committee was adjourned, subject to the call of the Chair.]

APPENDIX

[Testimony given to the committee on February 2, 1989, by the Honorable Alan Greenspan, Chairman of the Board of Governors of the Federal Reserve System, follows:]

STATEMENT OF HON. ALAN GREENSPAN, CHAIRMAN, BOARD OF GOVERNORS, FEDERAL RESERVE SYSTEM

Mr. Greenspan. Thank you very much, Mr. Chairman.

Let me say I very much appreciate those kind introductory remarks.

I would like to excerpt from my written copy and ask that the full transcript be included in the record.

Chairman Rostenkowski. Mr. Chairman, your entire statement will be included in the record, and you may proceed whichever way you would like.

Mr. Greenspan. I am pleased to be here today to discuss corporate restructuring and the need for reducing the Federal budget deficit, issues raised in your letter of invitation.

The spate of mergers, acquisitions, leveraged buyouts and divestitures in recent years has major implications for the American economy. While the evidence suggests that the restructurings of the 1980's probably are improving, on balance, the efficiency of our economy, the worrisome and possibly excessive degree of leveraging associated with this process could create problems for the financial system.

To fashion an appropriate policy response, if any, to this extraordinary restructuring LBO phenomenon, there are some key questions that must be answered. What is behind the corporate restructuring movement? Why is it occurring now in the middle and late 1980's rather than at some earlier time? Why has it involved such a broad leveraging of corporate balance sheets? And, finally, has it been good or bad for the American economy?

The 1980's has been a period of dramatic economic changes: Large swings in the exchange value of the dollar with substantial consequences for trade dependent industries, rapid technological progress, especially in automation and telecommunications, rapid growth in the service sector and large movements in real interest rates and relative prices. Clearly, such changes in the economic environment imply major, perhaps unprecedented, shifts in the optimal mix of assets at firms, owing to corresponding shifts in synergies and new opportunities for improving efficiency.

Some activities need to be shed or curtailed, and others added to or beefed up. Moreover, the long period of slow productivity growth in the 1970's may have partly exacerbated the buildup of a backlog of inefficient corporate practices.

When assets become misaligned or less than optimally managed, there is clearly an increasing opportunity to create economic value by restructuring companies, restoring what markets perceive as a more optimal mix of assets. But restructuring requires corporate control and it shouldn't be a surprise that in recent years unaffiliated corporate restructurers or "corporate raiders" have significantly bid up the control premiums over the passive investment value of companies that are deemed to have suboptimal asset allocations.

Observed stock prices do not always reflect values of shares as passive investments, but there can be for any individual company two or more prices for its shares reflecting the degree of control over a company's mix of assets.

Tender offer premiums, which represent the price that active investors are willing to pay for corporate control, ranged from 13 to 25 percent in the 1960's, but have moved to 45 percent and higher during the past decade, underscoring the evident increase in the perceived profit to be gained from corporate control and restructuring.

Interest in restructuring also has been spurred by the increased willingness and ability of corporate managers and owners to leverage balance sheets. The gradual replacement of managers who grew up in the Depression and developed a strong aversion to bankruptcy risks probably accounts for some of the increased proclivity to issue debt now.

Moreover, innovations in capital markets have made the increased propensity to leverage feasible. It is now, for example, much easier than it used to be to mobilize tremendous sums of debt capital for leveraged purchases of firms. The phenomenal development for the market for low-grade corporate debt, that is "junk" bonds, has enhanced the availability of credit for a wide variety of corporate transactions.

The tax benefits of restructuring activities are, of course, undeniable, but this is not a particularly new phenomenon. Our tax system has long favored debt finance by taxing the earnings of corporate debt capital only at the investor level while earnings on equity capital are taxed at both the investor and corporate level.

Evidence about the economic consequences of restructuring is beginning to take shape, but much remains conjectural. It is clear that the markets believe that the recent restructurings are potentially advantageous. Estimates range from $200 billion to $500 billion or more in gains to shareholders since 1982. These gains are reflections of the expectations of market participants, that the restructurings will in fact lead to a better mix of assets with companies and greater efficiencies in their use. This, in turn, is expected to produce marked increases in future productivity and hence in the value of American corporate business.

Many of the internal adjustments brought about by changes in management or managerial policies are still being implemented, and it will take time before they show up for good or ill in measures of performance. So far various pieces of evidence indicate that the trend toward more ownership by managers and tighter control by owners and creditors has generally enhanced operational efficiency.

In the process, both jobs and capital spending in many firms have contracted as unprofitable projects are scrapped. But no clear trends in these variables are yet evident in restructured firms as a group. For the business sector generally, of course, growth of both employment and investment has been strong.

If what I have outlined this morning is a generally accurate description of the causes of the surge in restructurings of the past decade, one would assume that a stabilization of interest rates, exchange rates, and product prices would slow the emergence of newly misaligned companies and opportunities for further restructuring. Such a development would presumably lower control premiums and reduce the pace of merger, acquisition, and LBO activity.

This suggests the most potent policies for diffusing the restructuring over the long haul are essentially the same macroeconomic policies toward budget deficit reduction and price stability that have been the principal policy concerns of recent years.

Whatever the trends in restructuring, we cannot ignore the implications of the associated heavy leveraging for broad-based risks in the economy. Other things equal, greater use of debt makes the corporate sector more vulnerable to an economic downturn or a rise in interest rates. The financial stability of lenders, in turn, also may be affected. Lenders to leveraged enterprises have been in large part those that can most easily absorb losses without major systemic consequences. They include mutual funds, pension funds, and insurance companies, which generally have diversified portfolios and have traditionally invested in securities involving some risk, such as equities.

To the extent that such debt is held by individual institutions that are not well diversified, there is, of course, some concern. At the Federal Reserve, we are particularly concerned about the increasing share of restructuring loans made by banks. Massive failures of these loans could have broad ramifications. We must resist, however, the temptation to seek to allocate credit to specific users through the tax system or through the regulation of financial institutions.

Restrictions on the deductibility of interest unavoidably involve an important element of arbitrariness, one that will affect not only those kinds of lending intended, but other types as well. Moreover, foreign acquirers could be given an artificial edge to the extent that they could avoid these restrictions. Also, the historical experiences with various types of selective credit controls clearly indicates that in time borrowers and lenders find ways around them.

All that doesn't mean that we should do nothing. The double taxation of earnings from corporate equity capital has added to leveraging, and thus debt levels are higher than they need or should be.

Unfortunately, our options for dealing with this distortion are severely constrained by the Federal Government's serious budget deficit problems, a matter that I will turn to in a moment.

One straightforward approach to this distortion, of course, would be a substantial reduction in the corporate income tax. Alternatively, partial integration of corporate and individual income taxes could be achieved by allowing corporations a deduction for dividends paid or by giving individuals credit for taxes paid at the corporate level. But these changes taken alone will result in a substantial revenue loss. An estimate of IRS collections from taxing dividends is in the range of $20 to $25 billion annually.

Dangers of risk to the banking system associated with high debt levels also warrant attention. As I have noted, the Federal Reserve in its role as a supervisor of banks has particular concerns in this regard. In 1984, the Board issued supervisory guidelines for assessing LBO-related loans, which are set forth in an attachment to my text.

These guidelines emphasize that the circumstances associated with highly leveraged deals require that creditors exercise credit judgment with special care, assessing those risks that are firm specific, as well as those common to all highly-leveraged firms. The Federal Reserve is currently reviewing guidelines for evaluating bank participation in highly leveraged financing transactions. We anticipate that this review will be completed shortly.

I would like to take a few minutes in addition this morning to concentrate on the budget deficit and the corrosive impact it is having on the economy. It is beguiling to contemplate the strong economy of recent years in the context of very large deficits and to conclude that the concerns about the adverse effects of the deficit on the economy have been misplaced. But this argument is fanciful.

The deficit already has begun to eat away at the foundations of our economic strength. And the need to deal with it is becoming ever more urgent. To the extent that some of the negative effects of deficits have not as yet been felt, they have been merely postponed, not avoided.

The damage to the economy occurs because deficits tend to pull resources away from net private investment, reducing the growth of the Nation's capital stock. This, in turn, has meant less capital per worker than would otherwise have been the case, and this will surely engender a shortfall in labor productivity growth, and with it a shortfall in growth of standards of living. Not surprisingly, we have already experienced a disturbing decline in the level of net investment as a share of GNP. Net investment has fallen to 4.7 percent of GNP in the 1980's from an average level of 6.7 percent in the 1970's, and even higher in the earlier decades. Moreover, it is not only by our own historic standards, but by international standards as well.

It is important to recognize that the negative effects of Federal deficits on growth in the capital stock may be attenuated for a while by several forces in the private economy. One is a long period of output growth in excess of potential GNP growth, such as occurred over much of the past 6 years, which undoubtedly boosts sales and profit expectations and hence business investment. Such rates of output cannot persist, making this factor inherently temporary in nature.

Finally, net inflows of foreign savings can be, as in recent years, an important addition to savings. In the 1980s, our ability to tap foreign savings has kept the decline in the gross investment/GNP ratio on average to only moderate dimensions.

But, the continuation of inflows of foreign savings at current levels is clearly questionable. Domestic investment tends to be supported by domestic savings alone in the long run.

Let me conclude, Mr. Chairman, by reiterating that the budget deficit must be brought down. I do not underestimate the difficult decisions that you must make if we are to achieve the necessary reduction in the deficit in the years ahead, but allowing deficits to persist courts a dangerous corrosion of our economy and risks potentially significant reductions over time in our standard of living.

Thank you very much.

[The statement of Alan Greenspan follows:]

Statement by

Alan Greenspan

Chairman, Board of Governors of the Federal Reserve System

Mr. Chairman and other members of the Ways and Means Committee, I am pleased to be here today to discuss corporate restructuring and the need for reducing the federal budget deficit, issues raised in your letter of invitation.

Corporate Restructuring and Leveraging

The spate of mergers, acquisitions, leveraged buyouts, share repurchases, and divestitures in recent years has major implications for the American economy. While the evidence suggests that the restructurings of the 1980s probably are improving, on balance, the efficiency of our economy, the worrisome and possibly excessive degree of leveraging associated with this process could create a set of new problems for the financial system.

Corporate restructuring is not new to American business. It has long been a feature of our enterprise system, a means by which firms adjust to ever-changing product and resource markets, and to perceived opportunities for gains from changes in management and management strategies.

However, the 1980s have been characterized by features not present in previous episodes. The recent period has been marked not only by acquisitions and mergers, but also by significant increases in leveraged buyouts, divestitures, asset sales, and share repurchase programs. In many cases, recent activity reflects the break-up of the big conglomerate deals packaged in the 1960s and 1970s. Also, the recent period has been characterized by the retirement of substantial amounts of equity (more than $500 billion since 1983) mostly financed by borrowing in the credit markets.

The accompanying increase in debt has resulted in an appreciable rise in leverage ratios for many of our large corporations. Aggregate book value debt-equity ratios, based on balance sheet data for nonfinancial firms, have increased sharply in the 1980s, moving outside their range in recent decades, although measures based on market values have risen more modestly.

Along with this debt expansion, the ability of firms in the aggregate to cover interest payments has deteriorated. The ratio of gross interest payments to corporate cash flow before interest provision is currently around 35 percent, close to the 1982 peak when interest rates were much higher and profits were weak owing to the recession. Lately, profits have been fairly buoyant; the current deterioration has been due to heavier debt burdens.

A measure of credit quality erosion is suggested by an unusually large number of downgradings of corporate bonds in recent years. The average bond rating of a large sample of firms has declined fairly significantly since the late 1970s, from A+ to A-.

To fashion an appropriate policy response, if any, to this extraordinary restructuring/LBO phenomenon, there are some key questions that must be answered: What is behind the corporate restructuring movement? Why is it occurring now, in the middle and late 1980s, rather than in some earlier time? Why has it involved such a broad leveraging of corporate balance sheets? And finally, has it been good or bad for the American economy?

The 1980s has been a period of dramatic economic changes: large swings in the exchange value of the dollar, with substantial consequences for trade-dependent industries; rapid technological progress, especially in automation and telecommunications; rapid growth in the service sector; and large movements in real interest rates and relative prices. Clearly, such changes in the economic environment imply major, perhaps unprecedented, shifts in the optimal mix of assets at firms--owing to corresponding shifts in synergies--and new opportunities for improving efficiency. Some activities need to be shed or curtailed, and others added or beefed up. Moreover, the long period of slow productivity growth in the 1970s may have partly exacerbated the buildup of a backlog of inefficient corporate practices.

When assets become misaligned or less than optimally managed, there is clearly an increasing opportunity to create economic value by restructuring companies, restoring what markets perceive as a more optimal mix of assets. But restructuring requires corporate control. And managers, unfortunately, often have been slow in reacting to changes in their external environment, some more so than others. Hence, it shouldn't be a surprise that, in recent years, unaffiliated corporate restructurers, some call them corporate raiders, have significantly bid up the control premiums over the passive investment value of companies that are perceived to have suboptimal asset allocations. If a company has an optimal mix and is appropriately managed, there is no economic value to be gained from restructuring and, hence, no advantage in obtaining control of a company for such purposes. In that case, there is no incentive to bid up the stock price above the passive investment value based on its existing, presumed optimal, mix of assets. But in an economy knocked partially off kilter by real interest rate increases and gyrations in foreign exchange and commodity prices, there emerge significant opportunities for value-creating restructuring at many companies.

This presumably explains why common stock tender offer prices of potential candidates for restructuring have risen significantly during the past decade. Observed stock prices generally (though not always) reflect values of shares as passive investments. But there can be, for any individual company, two or more prices for its shares, reflecting the degree of control over a company's mix of assets.

Tender-offer premiums--which represent the price that active investors are willing to pay for corporate control--ranged from 13 to 25 percent in the 1960s, but have moved to 45 percent and higher during the past decade, underscoring the evident increase in the perceived profit to be gained from corporate control and restructuring.

Interest in restructuring also has been spurred by the apparent increased willingness and ability of corporate managers and owners to leverage balance sheets. The gradual replacement of managers who grew up in the Depression and developed a strong aversion to bankruptcy risk probably accounts for some of the increased proclivity to issue debt now.

Moreover, innovations in capital markets have made the increased propensity to leverage feasible. It is now much easier than it used to be to mobilize tremendous sums of debt capital for leveraged purchases of firms. Improvements in the loan-sale market among banks and the greater presence of foreign banks in U.S. markets have greatly increased the ability of the banking sector to participate in merger and acquisition transactions. The phenomenal development of the market for low-grade corporate debt, so-called "junk bonds," also has enhanced the availability of credit for a wide variety of corporate transactions. The increased liquidity of this market has made it possible for investors to diversify away firm-specific risks by building portfolios of such debt.

The tax benefits of restructuring activities are, of course, undeniable, but this is not a particularly new phenomenon. Our tax system has long favored debt finance by taxing the earnings of corporate debt capital only at the investor level, while earnings on equity capital are taxed at both the investor and corporate levels. There have been other sources of tax savings in mergers that do not depend on debt finance, involving such items as the tax basis for depreciation and foreign tax credits. And taxable owners benefit when firms repurchase their own shares, using what is, in effect, a tax-favored method of paying cash dividends. In any event, the recent rise in restructuring activity is not easily tied to any change in tax law.

Evidence about the economic consequences of restructuring is beginning to take shape, but much remains conjectural. It is clear that the markets believe that the recent restructurings are potentially advantageous. Estimates range from $200 billion to $500 billion or more in paper gains to shareholders since 1982. Apparently, only a small portion of that has come at the expense of bondholders. These gains are reflections of the expectations of market participants that the restructuring will, in fact, lead to a better mix of assets within companies and greater efficiencies in their use. This, in turn, is expected to produce marked increases in future productivity and, hence, in the value of American corporate business. Many of the internal adjustments brought about by changes in management or managerial policies are still being implemented, and it will take time before they show up for good or ill in measures of performance.

So far, various pieces of evidence indicate that the trend toward more ownership by managers and tighter control by other owners and creditors has generally enhanced operational efficiency. In the process, both jobs and capital spending in many firms have contracted as unprofitable projects are scrapped. But no clear trends in these variables are yet evident in restructured firms as a group. For the business sector, generally, growth of both employment and investment has been strong.

If what I've outlined earlier is a generally accurate description of the causes of the surge in restructurings of the past decade, one would assume that a stabilization of interest rates, exchange rates, and product prices would slow the emergence of newly misaligned companies and opportunities for further restructuring. Such a development would presumably lower control premiums and reduce the pace of merger, acquisition, and LBO activity.

This suggests that the most potent policies for defusing the restructuring/LBO boom over the long haul are essentially the same macroeconomic policies toward budget deficit reduction and price stability that have been the principal policy concerns of recent years.

Whatever the trends in restructuring, we cannot ignore the implications of the associated heavy leveraging for broad-based risk in the economy. Other things equal, greater use of debt makes the corporate sector more vulnerable to an economic downturn or a rise in interest rates. The financial stability of lenders, in turn, also may be affected. How much is another question. The answer depends greatly on which firms are leveraging, which financial institutions are lending, and how the financings are structured.

Most of the restructured firms appear to be in mature, stable, non-cyclical industries. Restructuring activity has been especially prevalent in the trade, services, and, more recently, the food and tobacco industries. For such businesses, a substantial increase in debt may raise the probability of insolvency by only a relatively small amount. However, roughly two-fifths of merger and aquisition activity, as well as LBOs, have involved companies in cyclically sensitive industries that are more likely to run into trouble in the event of a severe economic downturn.

Lenders to leveraged enterprises have been, in large part, those that can most easily absorb losses without major systemic consequences. They include mutual funds, pension funds, and insurance companies, which generally have diversified portfolios and have traditionally invested in securities involving some risk, such as equities. To the extent that such debt is held by individual institutions that are not well diversified, there is some concern. At the Federal Reserve, we are particularly concerned about the increasing share of restructuring loans made by banks. Massive failures of these loans could have broader ramifications.

Generally, we must recognize that the line between equity and debt has become increasingly fuzzy in recent years. Convertible debt has always had an intermediate character, but now there is almost a continuum of securities varying in their relative proportions of debt and equity flavoring. Once there was a fairly sharp distinction between being unable to make interest payments on a bond, which frequently led to liquidation proceedings, and merely missing a dividend. Now the distinction is smaller. Outright defaults on original issue high-yield bonds have been infrequent to date, but payment difficulties have led to more frequent exchanges of debt that reduce the immediate cash needs of troubled firms. Investors know when they purchase such issues that the stream of payments received may well differ from the stream promised, and prices tend to move in response to changes in both debt and equity markets. In effect, the yields on debt capital rise toward that of equity capital when scheduled repayments are less secure.

In view of these considerations, and the very limited evidence on the effects of restructuring at the present time, it would be unwise to restrict arbitrarily corporate restructuring. We must resist the temptation to seek to allocate credit to specific uses through the tax system or through the regulation of financial institutions. Restrictions on the deductibility of interest unavoidably involve an important element of arbitrariness, one that will affect not only those types of lending intended but other types as well. Moreover, foreign acquirers could be given an artificial edge to the extent that they could avoid these restrictions. Also, the historical experience with various types of selective credit controls clearly indicates that, in time, borrowers and lenders find ways around them.

All that doesn't mean that we should do nothing. The contribution of our tax structure to corporate leveraging warrants attention. The double taxation of earnings from corporate equity capital has added to leveraging, and thus debt levels are higher than they need, or should, be. Our options for dealing with this distortion are, unfortunately, constrained severely by the federal government's still serious budget deficit problems, a matter that I will turn to in a moment. One straightforward approach to this distortion, of course, would be to substantially reduce the corporate income tax. Alternatively, partial integration of corporate and individual income taxes could be achieved by allowing corporations a deduction for dividends paid or by giving individuals credit for taxes paid at the corporate level. But these changes taken alone would result in substantial revenue losses; a rough estimate of IRS collections from taxing dividends is in the range of $20 to $25 billion annually.

Dangers of risk to the banking system associated with high debt levels also warrant attention. As I have noted, the Federal Reserve, in its role as a supervisor of banks, has particular concerns in this regard. In 1984, the Board issued supervisory guidelines for assessing LBO-related loans, which are set forth in an attachment to my text. These guidelines emphasized that the circumstances associated with highly leveraged deals require that creditors exercise credit judgment with special care, assessing those risks that are firm-specific as well as those common to all highly leveraged firms. The Federal Reserve is currently in the process of reviewing guidelines regarding the evaluation of bank participation in highly leveraged financing transactions; we anticipate that this review will be completed shortly.

The Budget Deficit and the Economy

The remainder of my prepared remarks will concentrate on the budget deficit and the corrosive impact it is having on the economy.

It is beguiling to contemplate the strong economy of recent years in the context of very large deficits and to conclude that the concerns about the adverse effects of the deficit on the economy have been misplaced. But this argument is fanciful. The deficit already has begun to eat away at the foundations of our economic strength. And the need to deal with it is becoming ever more urgent. To the extent that some of the negative effects of deficits have not as yet been felt, they have been merely postponed, not avoided. Moreover, the scope for further such avoidance is shrinking.

To some degree, the effects of the federal budget deficits over the past several years have been muted by two circumstances, both of which are currently changing rapidly. One was the rather large degree of slack in the economy in the early years of the current expansion. This slack meant that the economy could accommodate growing demands from both the private and public sectors. In addition, to the extent that these demands could not be accommodated from U.S. resources, we went abroad and imported them. This can be seen in our large trade and current account deficits. By now, however, the slack in the U.S. economy has diminished substantially. And as inflows of foreign saving are reduced along with our trade deficit, other sources of saving must be found, or demands for saving curtailed. The choices are limited; as will become clear, the best option for the American people is a further reduction in the federal budget deficit, and the need for such reduction is becoming more pressing.

Owing to significant efforts by the executive branch and the Congress, coupled with strong economic growth, the deficit has shrunk from 5 to 6 percent of gross national product a few years ago to about 3 percent of GNP today. Such a deficit, nevertheless, is still very large by historical standards. Since World War II, the actual budget deficit has exceeded 3 percent of GNP only in the 1975 recession period and in the recent deficit experience beginning in 1982. On a cyclically adjusted or structural basis, the deficit has exceeded 3 percent of potential GNP only in the period since 1983.

Government deficits, however, place pressure on resources and credit markets, only if they are not offset by saving elsewhere in the economy. If the pool of private saving is small, federal deficits and private investment will be in keen competition for funds, and private investment will lose.

The United States deficits of recent years are threatening precisely because they have been occurring in the context of private saving that is low by both historical and international standards. In the 1980s, net personal plus business saving in the United States has been about 3 percentage points lower relative to GNP than its average in the preceding three decades. Internationally, government deficits have been quite common among the major industrial countries in the 1980s, but private saving rates in most of these countries have exceeded the deficits by very comfortable margins. In Japan, for example, less than 20 percent of its private saving has been absorbed by government deficits, even though the Japanese general government has been borrowing almost 3 percent of its gross domestic product in the 1980s. In contrast, over half of private U.S. saving in the 1980s has been absorbed by the combined deficits of the federal and state and local sectors.

Under these circumstances, such large and persistent deficits are slowly but inexorably damaging the economy. The damage occurs because deficits tend to pull resources away from net private investment, which damps the growth of the nation's capital stock. This in turn has meant less capital per worker than would otherwise have been the case, and this will surely engender a shortfall in labor productivity growth and, with it, a shortfall in growth of the standard of living.

All else equal, the higher real interest rates associated with increased borrowing by the Treasury in the 1980s have reduced private investment in the aggregate. Moreover, the higher real interest rates have shifted the composition of investment away from long-lived assets, such as factories, toward computers and other shorter-lived equipment. The data also underscore a recent decline in the average service life of consumption as well as investment goods and a systematic tendency for this average to move inversely with real rates of interest. That is, the higher are real interest rates, the heavier is the concentration on short-lived assets.

Not surprisingly, we have already experienced a disturbing decline in the level of net investment as a share of GNP. Net investment has fallen to 4.7 percent of GNP in the 1980s from an average level of 6.7 percent in the 1970s and even higher in the 1960s. Moreover, it is low, not only by our own historical standards, but by international standards as well.

International comparisons of net investment should be viewed with some caution because of differences in the measurement of depreciation and in other technical details. Nevertheless, the existing data do indicate that total net private and public investment as a share of gross domestic product over the period between 1980 and 1986 was lower in the United States than in any of the other major industrial countries except the United Kingdom.

It is important to recognize as I indicated earlier that the negative effects of federal deficits on growth in the capital stock may be attenuated for a while by several forces in the private sector. One is a significant period of output growth in excess of potential GNP growth--such as occurred over much of the past six years--which undoubtedly boosts sales and profit expectations and, hence, business investment. Such rates of output growth, of course, cannot persist, making this factor inherently temporary in nature.

Another factor tending to limit the decline in investment spending would be any tendency for saving to respond positively to the higher interest rates that deficits would bring. The supply of domestic private saving has some interest elasticity, as people put off spending when borrowing costs are high and returns from their financial assets are favorable. But most analysts find that this elasticity is not sufficiently large to matter much.

Finally, net inflows of foreign saving can be, as recent years have demonstrated, an important addition to saving. In the 1980s, our ability to tap foreign saving has kept the decline in the gross investment-GNP ratio, on average, to only moderate dimensions (slightly more than one-half percentage point) compared with the 1970s, while the federal deficit rose by about 2-1/2 percentage points relative to GNP. Net inflows of foreign saving have amounted, on average, to almost 2 percent of GNP, an unprecedented level.

Looking ahead, the continuation of inflows of foreign saving at current levels is questionable. Evidence for the United States and for most other major industrial nations over the last 100 years indicates that such sizable foreign net capital inflows have not persisted and, hence, may not be a reliable substitute for domestic saving on a long-term basis. In other words, domestic investment tends to be supported by domestic saving alone in the long run.

Let me conclude by reiterating that the budget deficit must be brought down. I do not underestimate the difficult decisions that you must make if we are to achieve the necessary reduction in the deficit. But allowing deficits to persist courts a dangerous corrosion of our economy and risks potentially significant reductions over time in our standard of living.

ATTACHMENT

The Federal Reserve's directive to examiners on leveraged buyout loans, issued in 1984, provided the following supervisory guidance to supplement standard loan review procedures:

> The nature of leveraged buyouts and, in particular, the level of debt typically involved in such arrangements give rise to supervisory concerns over the potential risk implications for bank loan portfolios. The high volume of debt relative to equity that is characteristic of leveraged buyouts leaves little margin for error or cushion to enable the purchased company to withstand unanticipated financial pressures or economic adversity. Two principal financial risks associated with leveraged buyout financing are: (1) the possibility that interest rates may rise higher than anticipated and thereby significantly increase the purchased company's debt service burden; and/or (2) the possibility that the company's earnings and cash flow will decline or fail to meet projections, either because of a general economic recession or because of a downturn in a particular industry or sector of the economy. While either one of these developments can undermine the creditworthiness of any loan, the high degree of leverage and the small equity cushion typical of most leveraged buyouts suggest that economic or financial adversity will have a particularly large and negative impact on such companies. Thus, a leveraged buyout arrangement that appears reasonable at a given rate of interest or expected cash flow can suddenly appear to be questionable if interest rates rise significantly or if earnings should fail to provide an adequate margin of coverage to service the acquisition debt.
>
> In addition to unfavorable interest rate movements and earnings developments, adverse economic conditions may also have a negative impact on the value of a company's collateral. For example, if a general economic slowdown reduces a company's sales and earnings, the marketability and value of its collateral may also suffer. In any event, given the amount of debt involved in leveraged buyouts, the value of collateral is extremely important, and the risk that collateral coverage may be insufficient to protect the bank is a significant factor in evaluating the creditworthiness of these loans. In light of all of these considerations, the quality of a purchased company's management is also extremely important and represents another critical element in the bank's evaluation of leveraged buyouts. This is because such management must oversee both the special financial risks associated with the leveraged buyout form of acquisition financing as well as the normal day-to-day affairs and operations of the purchased company's business.
>
> In the course of on-site examinations, examiners should review a bank's involvement in leveraged buyout financing as well as the loans associated with individual leveraged buyouts. The following general

guidelines are provided to underscore and supplement existing loan review procedures.

1. In evaluating individual loans and credit files, particular attention should be addressed to i) the reasonableness of interest rate assumptions and earnings projections relied upon by the bank in extending the loan; ii) the trend of the borrowing company's and the industry's performance over time and the history and stability of the company's earnings and cash flow, particularly over the most recent business cycle; iii) the relationship between the company's cash flow and debt service requirements and the resulting margin of debt service coverage; and iv) the reliability and stability of collateral values and the adequacy of collateral coverage.

2. In reviewing the performance of individual credits, examiners should attempt to determine if debt service requirements are being covered by cash flow generated by the company's operations or whether the debt service requirements are being met out of the proceeds of additional or ancillary loans from the bank designed to cover interest changes.

3. Policies and procedures pertaining to leveraged buyout financing should be reviewed to ensure that they incorporate prudent and reasonable limits on the total amount and type (by industry) of exposure that the bank can assume through these financing arrangements.

4. The bank's pricing, credit policies, and approval procedures should be reviewed to ensure i) that rates are reasonable in light of the risks involved and ii) that credit standards are not compromised in order to increase market share. Credit standards and internal review and approval standards should reflect the degree of risk and leverage inherent in these transactions.

5. Total loans to finance leveraged buyouts should be treated as a potential concentration of credit and if, in the aggregate, they are sufficiently large in relation to capital, the loans should be listed on the concentrations page in the examination report.

6. Significant deficiencies or risks regarding a bank's leveraged buyout financing should be discussed on page 1 of the examination report and brought to the attention of the board of directors.

Chairman ROSTENKOWSKI. Thank you, Mr. Chairman.

Mr. Chairman, I am concerned with the economic outlook with respect to interest rates. In 1990, the CBO baseline outlays are almost $14 billion higher than the estimates by the administration due to higher interest rate forecasts. The CBO forecast is very close to many private forecasts and the blue chip consensus of business forecasts, while the administration interest rates are considerably lower. The CBO forecasts that the interest rate on 3-month Treasury bills will average 7.9 percent this year and 7.1 percent next year, while the administration's budget assumes that interest rates will average 6.3 percent this year and 5.5. percent next year.

What, Mr. Chairman, do you believe the chances are that interest rates will fall to the levels assumed by the administration this year and next? What are the chances that interest rates, that is 3-month T bills, will fall to 3 percent in 1994 as the administration assumes?

Mr. GREENSPAN. Mr. Chairman, I think it is important to differentiate between the nature of a forecast such as that made by the Reagan administration in its budget and the conventional forecasts made by private economists, and even CBO, when it is looking at its current services budget. Of necessity, the administration, any administration, will assume in its economic forecast that its budget proposals will be enacted fully and expeditiously.

As I have said elsewhere if we do get a very dramatic decline in the budget deficit, then it is credible to forecast that interest rates will decline. The markets will drive them down. I think that the interest rate estimates in the current Reagan budget for 1989 are low. That is, interest rates were higher in the fourth quarter of 1988 than they were forecasting, and that undershoot came into 1989, and it would be very difficult for them to reach their 1989 target.

Nonetheless, I do not think that they are going far overboard in presuming that rates would decline if the deficit followed the path they are suggesting. I don't want to comment on specific differences between the CBO and OMB forecasts, but I think it is important to recognize that at least in the short run the differences in real growth between the OMB forecast and the CBO and other forecasts are really not very large.

I do think that the CBO forecast is probably more likely to prevail and its real-growth numbers are more likely to prevail than OMB's, but I think we are stretching the capability of forecasting to really argue strenuously one way or the other. Although, the current estimate for 1989 by OMB is not the number I would put down, we would only be fractionally different from that. We just cannot forecast as accurately as the difference between, say, CBO on the one hand, which is a little under 3 percent for this year, and OMB, which is 3.5 percent. Anyone who can forecast real growth within one-half of 1 percent a year in advance gets a medal.

Chairman ROSTENKOWSKI. Thank you, Mr. Chairman.

Mr. Rangel.

Mr. RANGEL. Thank you, Mr. Chairman.

I think the Nation is indeed fortunate, Mr. Chairman, to have you at the Federal Reserve. Since our chairman has taken the liberty to go outside of the scope of your testimony on LBO's, let me ask whether or not it falls within your jurisdiction to view the investment that this country is making in education and in training of people that ultimately will be absorbed in society to be able to have the type of productivity that is going to be so necessary if indeed we are going to be competitive and we are going to increase the GNP?

I know as an economist, and I know the awesome responsibilities that you have, that sometimes this just looks like a domestic issue that the Congress has to wrestle with. But, I wonder whether you have taken an overview as to what this country has to do to be truly competitive in trade. That is the end of my question.

Mr. GREENSPAN. Well, Congressman, I think you are raising a very important issue. Although we tend to emphasize the close relationship between capital investment on the one hand and productivity on the other, as well as the relationship between productivity and standards of living, education is also very important in the growth process. I must say that I am quite concerned that our educational levels are not where they have to be in order to maintain increased investment in technology.

We are going to need a highly educated work force to run the system in the decade ahead, and anything we can do to enhance our educational capabilities is clearly a major plus for economic growth.

It is, however, a spending priority which must compete with other spending priorities. But whatever can be done for education, especially without money, is very important, and whatever can be done with appropriated funds should be very carefully looked at.

Mr. RANGEL. People are laughing when you say without money, because that seems as though it is the direction the administration is going. They are concerned and have priorities for everything, but without money. But, I will accept that, except what bothers me more than the budget restraints is the fact that I think this administration, as the previous one, truly believes that the educational responsibility is a local and State responsibility, and you as Chairman of the Federal Reserve Board and other people who are concerned with our international posture, you are really saying it is a national responsibility.

I am not talking about the funding, I am talking about the obligation, the philosophy.

Mr. GREENSPAN. Congressman, I certainly agree that education is a crucial issue in the maintenance of economic growth and the stability of our economy.

On the question of how it is financed, that is an issue which I leave to those more knowledgeable on the subject than I. I can only agree that there is an economic dimension to this of a very significant order.

Mr. RANGEL. I see that, Mr. Chairman, it is a contradiction to say that we have a national and international problem in order to be competitive, and we need a well-trained work force, and we are going to leave it to the mayors and Governors how and if it is going to happen. But you have normally been right in the past, and I hope that you are still correct.

Thank you very much.

Mr. GREENSPAN. Thank you.

Chairman **Rostenkowski**. Mrs. Johnson will inquire.

Mrs. **Johnson**. No questions, Mr. Chairman.

Chairman **Rostenkowski**. Mr. McGrath.

[No response.]

Chairman **Rostenkowski**. Mr. Frenzel will inquire.

Mr. **Frenzel**. Thank you, Mr. Chairman, and thank you, Chairman Greenspan, for your testimony on the subject which, as I understand it, carries a multiple instruction to us, the first of which is to not meddle with the deductibility of interest at this point, but rather to seek a solution in relief of the double taxation of dividends; and, second, do something in a hurry about the deficit because that is gumming up everybody's problem.

If this committee were to follow what seems to be an important thought running through Washington, that is nail some of the interest and then trade it off for some of the dividends, would you consider that a violation of your instructions to us?

Mr. **Greenspan**. Well, I certainly don't consider myself giving instructions to the Congress.

Mr. **Frenzel**. Sharing your wisdom with us.

Mr. **Greenspan**. I like that better.

Mr. **Frenzel**. We are going to be degrading the value of your wisdom?

Mr. **Greenspan**. I like that better. I will comment further, however.

The problem that I have with altering the deductibility of interest, which I must say I have given considerable thought to, is it is difficult to do without inducing undesirable secondary consequences. The basic problem that you have is the extraordinary complexity of economic structure and the ability of thoughtful corporate lawyers to restructure organizations and who borrows from whom in a manner which would gradually diminish the effect of reducing the deductibility of interest.

I would much prefer that Tax Code subsidies for corporate restructuring be resolved on the equity side as distinct from the interest side. I think that is likely to have a straightforward effect. It will remove the subsidy for debt and will not produce, as best I can judge, adverse consequences.

Mr. **Frenzel**. Thank you. We do too. We don't know where we get the money in the budget to do it effectively.

May I ask, however, something different, and that is you have a regulation in place already which some people allege would solve the problem, at least—it has to do with the 50-percent margin requirement on borrowed money which relates to acquisition problems.

You and I have corresponded on this matter, and it was the opinion of the Fed that the aggrieved party should go into court and put that regulation to use. The courts don't seem to think that they have status, and I believe the Board has corresponded with the SEC about its interest in enforcing your regulation.

Can you at this time comment, or if you cannot, could you comment for the record at some later time on using regulations that are already in force where they can be used to help mitigate the problem that is before us?

Mr. **Greenspan**. Congressman, it is our view that the margin requirements are ill-suited for this particular use in the sense that only a court can adjudicate the crucial questions of fact to determine whether a particular transaction violates the margin requirements.

We have suggested that the best method of improving compliance with margin requirements is to provide a private right of action which would enable facts to emerge in an appropriate way.

I will, however, add to my comments formally and at least outline for you some of the concerns we have with respect to this problem and how we think it would be best resolved.

[The information follows:]

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

ALAN GREENSPAN
CHAIRMAN

March 16, 1989

The Honorable Bill Frenzel
House of Representatives
Washington, D.C. 20515

Dear Congressman:

During the hearing before the Ways and Means Committee on February 2, you requested additional information on the enforcement of margin regulations in corporate takeover transactions. I am furnishing the enclosed response to the Committee for inclusion in the record of the hearing.

Please let me know if I can be of further assistance.

Sincerely,

Further Comments of Chairman Greenspan concerning Enforcement of Margin Regulations in Corporate Takeover Transactions.

Under the margin regulations as currently written, the limits on the amount of credit that can be extended apply only where credit used for the purpose of buying margin stock is directly or indirectly secured by margin stock. *See* 12 C.F.R. 207.3(b). In cases where this kind of credit is directly secured by margin stock, for example, where margin stock is pledged as collateral, determinations about compliance with the margin limits are usually straightforward. When there is an allegation that a particular credit transaction is indirectly secured by margin stock, as is typically the case in contested takeover situations, any judgment as to whether the margin regulations will be violated almost always depends on the specific characteristics of each transaction.

Under the current margin rules, the concept of indirect security includes a wide variety of arrangements between lenders and borrowers where the lender is relying as a practical matter on margin stock as collateral for the credit, even though the lender does not have a conventional security interest in the stock. 12 C.F.R. 207.2(f) & .112(d). Making these kinds of assessments about what lenders are in fact relying on as collateral in a particular case typically requires an examination of the subjective intent of the parties. For example, it may be necessary to review the terms of the financing transaction and the financial condition of the borrower and decide whether a reasonable person would extend credit in such a situation without requiring the pledge of stock to be acquired.

The agencies charged with administrative enforcement of the margin regulations, the Federal Reserve and the SEC, do not always have immediately available the resources needed to conduct this kind of inquiry, which invariably must be undertaken on an expedited basis. Thus, the existing mechanism for administrative enforcement of the margin regulations may not always provide an effective remedy for margin regulation violations in contested corporate acquisitions. The agencies' task is further complicated by the fact that the financing arrangements for these kind of transactions tend to be unique to that transaction, so that the specific characteristics of the lender-borrower relationship have to be delved into in each case. In addition, in many cases, the terms of proposed credit transactions that will finance a tender offer can be changed several times while the tender offer remains open.

Because of these problems, we have for many years advocated that there be a private right of action that would permit affected parties to bring suit directly against lenders, borrowers, or other interested parties to remedy margin regulation violations. This seems to make especially good sense in the takeover area, where the target companies have the incentive and the resources to press for prompt adjudication of margin regulation issues in the courts. Without the availability of such a remedy, there will not be an appropriate mechanism for enforcement of the margin rules in every case.

Mr. **Frenzel**. Thank you very much, Mr. Chairman. My time has expired.

Chairman **Rostenkowski**. Mr. Stark may inquire.

Mr. **Stark**. Thank you, Mr. Chairman.

Welcome, Chairman Greenspan. I would like to also take the liberty of straying a little bit from your prepared text and suggest while many of us are unsure about the effect of LBO's and what the budget growth in the country will or won't be, I think we could all agree that there is about $100 billion staring us in the face in the savings and loan question, and some of us would suggest that maybe the thing to do is to take the approximately 350 S&L institutions that are technically bankrupt, close them, sell the assets as best we can, pay off the depositors or transfer them to healthy institutions and reform the regulatory system and lump it into one that has at least as good a record as your own institution does in regulating financial institutions. We should swallow the cost as fast as we can, recognize that it is a national obligation to pay for it. Doing it more quickly will save us interest, as the sick institutions drive up the rate the rest have to pay.

Could the Feds live with such a system, or would you have an alternate approach to solving that problem?

Mr. **Greenspan**. Well, Mr. Stark, as you well know, the Treasury Department, in conjunction with the Federal Reserve, Office of Management and Budget, Comptroller of the Currency, and the FDIC, has been discussing this issue at some length, and considerable progress has been made toward a sensible set of recommendations.

The Treasury, which clearly has the lead here and is spending a considerable amount of analytical effort to evaluate a wide variety of separate proposals, will shortly be presenting their results to the President, and I would assume because hearings are currently scheduled and the President does have a budget message, that very shortly details of the overall proposals will emerge.

My recollection is the Secretary Brady is scheduled to testify before the Congress in 2 or 3 weeks, and at that point I think a full proposal will be forthcoming.

Mr. **Stark**. Just one more question. After the proposal has been floated, will you be inclined to offer your comments on the proposal?

Mr. **Greenspan**. Yes, I will, Mr. Stark. I am planning to testify shortly thereafter.

Mr. **Stark**. Thank you very much.

Chairman **Rostenkowski**. Mr. Russo.

Mr. **Russo**. Thank you very much.

Mr. Chairman, as someone who sits on the Budget Committee and having listened to four leading economists last week, their scenario foresaw a hard landing should we not act responsibly on the budget. I think one of the critical things we have to confront is economic assumptions. I think it is very important that you set the stage early, what you think your forecasts are, because if we make a mistake, in September we will have to pay for it.

As I understand it, for every point in the percentage of interest we are off, it costs $11 billion. So if the administration is 2 percentage points off and CBO is right, then we're already $22 billion off in our interest rate assumptions, and for every one point in growth, you lose $22 billion. And so right now there is about 6 percentage points, about half a percentage point difference there, so that is another $12 billion. You are talking pretty close to about $34 billion in estimates that they are miscalculating right now.

If CBO is accurate, we are going to have to make this gap up sometime in September if we have to go to sequestration. So I happen to believe these economic assumptions are important in terms of how we establish our priorities and the kinds of revenues we are struggling with in the Budget Committee. Whatever the administration assumes, we are going to accept it or we have to make up the $34 billion, and that seems to be the game we have played the last 4 years I have served on the Budget Committee.

Let me ask you this, What should our ultimate deficit reduction target be? Should the goal be to balance the budget, should we run a surplus, and how much should we cut the budget each year in a way that would not trigger recession if we cut too much too soon?

I would like you to comment on the use of the social security trust funds to reduce the budget deficit. Sometime in the future we are going to have to redeem the bonds they are being invested in. Should we have a budget deficit target that includes Social Security, or should we have a budget deficit goal that does not include the Social Security surplus?

Mr. GREENSPAN. Well, first, Congressman, let me say that the speed of adjustment that is embodied in Gramm-Rudman-Hollings is about as good an adjustment process as I can envisage so far as time is concerned. Owing to the shortage of domestic savings, we may very well have to move toward a Federal surplus in order to offset that shortage.

So even though Gramm-Rudman-Hollings moves only to a balanced budget, I think the long-term goal of the Congress should be to create some modest ongoing unified budget surplus rather than just really seek balance per se. We could move faster than Gramm-Rudman-Hollings without disrupting the economy because, as I indicated to the chairman, should there be a credible, rapid decline in the Federal budget, interest rates would fall rather significantly, and the decline in the budget deficit would be offset by increased underlying capital investment as a result of lower interest rates. As a result there would be a balance in the losses to effective demand and in the increases in effective demand.

So I would not be concerned about overdoing the rate of adjustment.

Mr. RUSSO. Mr. Chairman, if I could—I want to get into that response on Social Security. But, as I understand the 1989 budget, and the markets are not stupid, the markets understand the games that are being played in terms of the budget deficit, that if you take the Social Security trust fund off budget and not really count it, in 1989 that generated $41 billion in surplus, while all other trust funds had a $55 billion surplus. So added together, we reduced the budget deficit by about $96 billion down to $151 just by the use of the trust fund surplus, an accounting procedure that didn't really reduce the budget deficit.

So for the financial markets the budget deficit for fiscal 1989 really was $247 billion, and not the $151 billion figure that is reported by counting the trust funds. Is that a good idea, to count the trust funds? Because the Social Security surplus is going to be growing to as much as $200 billion a year. That will reduce the deficit, but is it really reducing the deficit?

Mr. GREENSPAN. Well, let me say, Mr. Russo, that the financial markets are focused almost exclusively on the unified budget deficit, because that is the deficit which has to be financed in the private markets. Remember that Social Security invests in U.S. Treasury securities directly. The result of that is an emphasis on where both the short-term and long-term unified deficit are going. And while markets certainly acknowledged the question you raise, namely the differences between the trust funds and the other parts of the budget, they view the trust funds as financing the rest of the budget, and it is only the net which essentially concerns them with respect to the effects on markets, the effects on the supply and demand for credit.

Mr. RUSSO. But some day we have to redeem those funds, and, as I understand it, we are going to be into the trillions and trillions of dollars in the year 2010 to 2015, and we are going to have to pay for those bonds somewhere down the line on the revenue side of our ledger.

Mr. GREENSPAN. That is certainly the case.

Mr. RUSSO. I am a baby-boomer, and I want it there when I retire, you know. You seem very optimistic about it.

Mr. GREENSPAN. Keep in mind that in the unified budget the interest payments that are made from the Treasury to the Social Security trust fund is washed out. It is an intragovernmental payment.

But if you separate Social Security from the rest of the budget, that payment of interest from the Treasury to the Social Security trust fund, which is, one of the reasons why the Social Security trust fund rises so rapidly is an outlay in the other part of the budget. And so while interest payments to the Social Security trust fund is a major factor helping the fund increase very sharply, separating Social Security will also create an accelerating deficit on the rest of the budget.

So it is going to create some very serious problems for the Budget Committee if one tries to split those apart.

Mr. RUSSO. If you did that, wouldn't you put your budget targets higher? Instead of being zero, you would have to make them higher.

Mr. GREENSPAN. Yes, definitely.

Mr. RUSSO. Thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. Schulze. Mr. Sundquist. Mr. Downey?

Mr. DOWNEY. Mr. Chairman, it is good to see you. Not only do I consider you a fine Chairman of the Federal Reserve, and your testimony is much welcomed today, but a consummate diplomat, and sometimes I have the feeling you are driving around the flame, a moth around a flame afraid to be consumed by a position that may send the markets one way or the other.

But I am going to try to pin you down a little bit, if I can, today because we have to deal with specifics, and while I agree completely with the notion we have to reduce the deficit and do it soon by either spending or tax increases, the realities have been stated to you by Congressmen Russo and Stark and by countless others, that there are priorities out there that will require us to spend money, defense considerations that will not allow us to cut the budget there by much, and domestic priorities that will not allow us the reduction.

So that leaves us with the painful reality of raising revenue, in my view. And I approach this, I suppose, the same way a doctor learns the Hippocratic oath, the first few lines of which are first do no harm, and that is how I view the American economy. If we have to raise revenue to achieve Gramm-Rudman targets this year, can you be somewhat specific in terms of what sort of tax increase you think would do harm, how large an increase would do harm?

And then I am going to ask you about some specific measures in terms of amounts and types of increases that you might elaborate on. First I would like to ask you how big a tax increase if we decide to reach the Gramm-Rudman levels would you be supportive of and do you think would not harm our economy?

Mr. GREENSPAN. Well, first of all, it would be highly desirable to try to resolve the budget deficit problem wholly from the expenditure side. I say that largely because I am fearful that if we try to resolve the long-term deficit problem through taxation we are going to find that it works only in part, perhaps only a small part, because we will eventually find that expenditures creep up and absorb the new revenues.

All taxes do harm. The issue is not finding which of them is harmless—there are none—but finding which do less harm than others. And I have for a number of years, not for revenue purposes, but for economic structure purposes, been strongly supportive of a gasoline tax. And the reason that I have been strongly supportive of it is that it does only a modest amount of harm and promotes conservation.

So that while I wouldn't argue for it as a revenue-raiser, because I strongly believe that we should endeavor to resolve the deficit from the expenditure side, I do think that a gasoline tax makes sense because it would significantly restrain the renewed growth in oil consumption.

Mr. DOWNEY. Among evils, would, if I can try and pin you down a bit more, a gasoline tax of 5 cents, let's say, a gallon, increase by 5 cents by over 3 years, what sort of harm do you think that would do to the economy as opposed to, let's say, other excise taxes or possibly eliminating the bubble on the top rate, where we currently, as you know, have a 33-percent rate, at that point is 150, goes back down to 28, as opposed to eliminating that, would a gasoline tax of 5 cents a gallon over 3 or 4 years——

Mr. GREENSPAN. I think that the 1986 Tax Act came out rather well. I would be most reluctant to alter the marginal rate patterns, because I think that considerable good will eventually come from them.

In fact, much good has already come from those changes. I would be most reluctant to see higher rates.

The problem with taxes which embodied themselves in the cost of doing business is that they distort the system. In other words, an oil import fee becomes embodied in the cost of petrochemical feed-stocks and residual fuel and the like, and that will have negative effects. Only in a very small part is that true of a gasoline tax.

I would strongly prefer to stay away from all cost increasing taxes. Increases in either the corporate income tax or the individual income tax would be most unproductive.

Mr. DOWNEY. Thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. Vander Jagt?

Mr. VANDER JAGT. Thank you, Mr. Chairman.

Welcome, Mr. Chairman, back home, where you have been so many times before.

My question arises out of your statement on page 8 that we must recognize that the line between equity and debt has become increasingly fuzzy over recent years. I think the gist of the testimony we have listened to for 3 days is that one of the contributing factors to the stampede to LBO's is how we treat equity and debt in our society and in the Tax Code.

One of the things we have all been fascinated with is "why the sudden surge of LBO's?" One of the answers given by the Secretary of Treasury and others was that it was only recently that Wall Street figured out how to take advantage of this, which would lead me to believe that over the years it has always been difficult to define clearly, for tax purposes anyway, the difference between debt and equity.

Wall Street finally figured out how to push it farther and farther and farther and make more of equity into debt. That is what we have.

My question to you is, as just one small step in addressing this crisis, wouldn't it help to give a more clear definition of debt and equity and maybe define debt as Wall Street used to think it was defined before they went into the junk bonds?

If I could expand on this thought one step further. Maybe one of the ways to get into defining it is to look at a case where junk bonds are returning 17 percent on interest when the prime rate is 10 percent.

Obviously, some of that high interest rate is not just for the use of money; there is an acquisition of an equity there. Is there any way that we can give a more clear definition of the difference between debt and equity?

Mr. GREENSPAN. Congressman, I am afraid you are resurrecting matters that have been discussed in the Internal Revenue Service now for a number of years.

Mr. VANDER JAGT. Especially between 1969 and 1982?

Mr. GREENSPAN. Yes, indeed.

It is a very difficult problem because of the number of instruments that we have. When you try to put bells and whistles on those instruments, it is very difficult to know just how close you are to debt or equity. It is getting ever-increasingly like a continuum.

That creates a significant definitional problem for the Internal Revenue Service. They have been struggling with that problem, as indeed have the courts.

I naively asked at one point to get a simple definition of what is debt and what is equity. I ended up with a stack like that in which the answer is not yet there.

It may well be that we will have to live with that ambiguity for a while. But there is no question that there are instruments which are debt-like, which have part of their return in an equity form.

In fact, they build them that way. How one struggles to get the appropriate application of principle that you raise and with which I fully agree is going to be extremely difficult.

I am not sure that the Congress can do it.

It probably has to be done by the Internal Revenue Service, which is already required to make this distinction.

Mr. **Vander Jagt**. Mr. Chairman, maybe I am as naive as you were when you asked the naive question of a simple definition between debt and equity and got the big stack of papers.

Maybe part of the problem in the struggle of trying to define is that they were dealing with it in too complex a way and didn't recognize that there never is going to be a perfect answer. Perhaps we should start looking in more naive and simple ways. Let me just throw out one suggestion as a groping toward it.

One could argue that all debt is partially a reaching for equity. Even if you just plain borrow money to save a failing company or to keep it alive, you are trying to retain the value of the equity. One of our witnesses yesterday said that if you reduced the deductibility of interest to 86 percent—and maybe that 14 percent would be recognizing some equity even in a debt interest instrument—you could then reduce the deductibility of dividends by 50 percent and it would be revenue neutral. Since there is a gap between how we treat equity and debt, wouldn't that be a constructive step in the right direction, or not?

Mr. **Greenspan**. Well, I am not sure. I don't know that the revenue estimates——

Mr. **Vander Jagt**. That was just one witness' testimony. I am not sure either.

Mr. **Greenspan**. The difficulty that you get into when you try to limit interest deductions is that you will cause secondary consequences.

What about banks or finance companies who have huge amounts of interest coming in and huge amounts of interest coming out? Are they included?

Obviously, if you did include them, you would throw them out of business. And if you didn't, what you would find is that nonfinancial corporations would then all proceed to buy financial corporations.

It would cause an extraordinary change in the optimum mix of assets in the economy. I think it would itself create a large wave of new corporate restructuring, which I am not sure would be particularly desirable.

So that before you move in that direction, I think it is very important to go step by step and ask what happens if you do "X" or "Z"?

Mr. **Vander Jagt**. Thank you, Mr. Chairman.

It is very helpful.

Thank you, Mr. Chairman.

Chairman **Rostenkowski**. Mr. Guarini.

Mr. **Guarini**. Dr. Greenspan, it always is good to see you again. Thank you for your wisdom and your counsel.

We live in a speculator's paradise fueled by mountains of borrowed money, shifting assets, rather than creating wealth, spending time in board rooms and manipulating numbers instead of becoming more productive in the plant. Some people feel, of course, that the greed within our society has gotten to the point that it has actually hurt our productivity.

I am extremely concerned about the level of debt we have. We can get into the philosophy of what is debt, what is equity.

The fact is we have got to recognize that we do have a big Federal budget deficit of $100 billion, assuming we get down to Gramm-Rudman this year. The national debt is $2.7 trillion, which carries a debt service of about $160 billion.

I am concerned about the rising interest rates if a recession hits. Our S&L crisis has a potential cost of $100 billion.

Third World debt in Latin America is $400 billion alone. We keep shifting from equity to debt in our corporate structures with the LBO's. I am wondering whether or not we are not poised for an extremely dangerous position in our economy.

The problem of compounding higher interest rates in a recession can cause a very calamitous effect. I am wondering what your comments are on raising interest rates in a climate like that and whether or not we are overburdened by debt governmental and corporate wise. Every place we turn in our society the same national debate is taking place.

It is always more indebtedness whether we are in the public or the private sector. Can you comment on what happens if we have higher interest rate and what happens if a recession does take place?

Mr. GREENSPAN. First of all, there is no question that the debt burden, however we define it, has been rising and rising very substantially in the private sector. The figure which I find most troublesome is the rise in interest payments for nonfinancial corporations as a percent of a corporate cash-flow before the interest provision. This statistic is up to 35 percent, and a multiple of what it was two or three decades ago.

Obviously, should we run into a recession and corporate cash flow contracts dramatically, excess fixed costs in the system will create very severe problems and would exacerbate the underlying economic structure.

It is precisely because we are concerned with inflationary acceleration, which in turn would lead to very high interest rates and break the back of the economy and lead to the types of difficulties that we are concerned about, that the Federal Reserve throughout 1988 kept ahead of the curve, so to speak, by trying to keep inflationary expectations down. That led, of course, to a moderate rise in interest rates.

But our purpose was to prevent problems from emerging which would have been far more deleterious to the structure and far more of a worry with respect to our debt service problems than any actions that we are taking.

We are very sensitive to the impact of interest rates on the economy, and we hope that our actions will make the interest rate path much lower than it otherwise would be.

Mr. **Guarini**. Should we keep interest rates down by putting a floating cap on the subordinated loans being made which run 18 percent and 20 percent, et cetera, where there is secondary lending taking place at extremely high rates, irresponsible rates sometimes?

Mr. **Greenspan**. I think what we have to distinguish between is the level of risk-free and risky interest rates. By that we usually mean the riskless rates of interest, those substantially involved in U.S. Treasury securities, and the wide variety of other debt instruments that are involved with significant premiums over the riskless rate.

This gets to the question that Mr. Vander Jagt raised, namely, the issue of when do we have debt and when do we have equity?

Many of these extraordinarily high interest, so-called interest paying debt instruments are really partial equity instruments, and it is difficult to make the differentiation.

I would be hesitant to try to arbitrarily cap any of those because what you will succeed in doing is merely eliminating them.

Mr. **Guarini**. How about if you have five points above prime or floating or whatever it is? You have flexibility in there.

Mr. **Greenspan**. You are talking about capping interest rates?

Mr. **Guarini**. Right. We had laws making it illegal beyond a certain rate. I am wondering whether or not these high rates are hurting our economy and making LBO's possible?

Mr. **Greenspan**. I think you will find that if you cap interest rates which are determined in the marketplace, the person who has to pay that interest will not be able to fund in general.

The question you have to ask yourself is that if you cap the rate, what will happen? The answer almost surely is that the lender will disappear and the borrower will not have any source of funds.

Mr. **Guarini**. That might be fine in LBO's.

Thank you, sir.

Mr. **Pease**. I think it is quite understandable, Mr. Chairman, that you did not want to disagree publicly with the Administration on its economic assumptions. You also don't want to shake up the markets by doing so.

I must say I am concerned that your desire not to disagree with the Administration may not well serve this committee or the nation. As an example regarding deficit reduction, you declined to disagree with the administration's economic assumptions for the current budget.

You stated this morning that should the full Reagan budget deficit reduction be adopted, the economic assumptions in the Reagan budget are credible. As Mr. Russo said, the deficit reduction in the Reagan budget, is the result of rosy economic assumptions. Reductions are rather small part of the deficit reduction package.

Are you saying that making the small outlay reduction will lead to the higher growth levels, lower interest rates, and lower inflation predicted by OMB?

Mr. **Greenspan**. Well, remember, Congressman, the budget I have in mind is not only the budget for fiscal year 1990. It is the total budget which implies fairly significant decline in fiscal year 1991 and beyond.

I will state, and I will just repeat because it is actually the case, I am not trying to support the administration. I wouldn't and haven't in the past when I have disagreed.

I am merely saying it is important to understand the implications of that forecast. I am saying and I will repeat, irrespective of how it is done, if the pattern of outlays develops as they propose in fiscal year 1991, 1992, and 1993, and is locked in through authorizations and appropriations, the markets would respond very favorably and interest rates would come down.

I am not saying whether they would come down directly, exactly as I have not looked at their interest forecasts and detail in the context of all this, so I cannot apprise whether the numbers are appropriate. But that interest rates would come down and come down significantly under those conditions, I have, frankly, no doubt.

Mr. PEASE. You have no doubt even if in reality we do not meet the Gramm-Rudman targets?

Mr. GREENSPAN. If the Gramm-Rudman targets are not being met and the markets perceive that they are not being met, interest rates will not come down anywhere near the extent forecast by the administration.

Mr. PEASE. Doesn't that suggest that if the Gramm-Rudman targets are being met by the projections of the administration or by the budgets adopted by Congress in a way that involves rosy economic assumptions rather than substantial outlay cuts, that the deficit reductions are nonetheless satisfactory?

Mr. GREENSPAN. Well, first of all, I was saying that the calendar year 1989 forecasts, which are only in real terms about a half a percent point above where the consensus are well within the range of forecast error.

I would not argue that that is out of line, as I answered earlier to the Chairman. I do find that their longer term forecast to be above what we would consider to be the long-term potential of the economy.

I have discussed that in some detail before the House Banking Committee fairly recently. But I think it is important to remember that any administration has a dilemma in its forecast in that it has to presume that the Congress enacts the budget that it brings forth, and that has certain economic consequences which puts that type of forecast in a different category from most other forecasts, which don't have that restriction on.

Mr. PEASE. Mr. Chairman, I appreciate your comments. You spoke before about the corrosive impact of deficits. My question is whether those corrosive impacts are going to be ameliorated if Congress uses the President's economic assumptions and adopts a budget where we meet the Gramm-Rudman targets, but does so in a sham manner so that any knowledgeable economist knows when we pass it—and we know—that it is at least $20 billion off.

Won't the real deficit be $20 billion higher than we stated when we allegedly met the Gramm-Rudman targets?

Mr. GREENSPAN. I think the markets obviously are aware that there is a difference between the Gramm-Rudman targets and what actually occurs after the fact.

At an earlier testimony, I think it was Tuesday, at the Joint Economic Committee, I said that if the budget deficits were actually brought down in fiscal year 1990 to $110 or $120 billion—I mean actually after the fact—that would be perceived by the markets very favorably.

But I do think that markets look at the Gramm-Rudman process as being useful and as a mechanism which helps to bring the deficits down. I don't think they are being unrealistic about that.

Mr. PEASE. Thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. Matsui.

Mr. MATSUI. I also would like to thank you, Mr. Greenspan for your testimony.

When we started this process, most of us were suggesting that perhaps there could be some revenue gain by solving problems in the area of leverage buyouts. I am finding that is wishful thinking.

In fact, the solution we want to develop would probably create a revenue loss because the action should be to limit the double taxation of dividends rather than to limit interest deductions. Limiting deductibility of interest would make it easier for foreigners to purchase companies and increase the cost of capital.

You have pretty much ruled out disallowing some of the interest deduction as a way to pay for the deductibility of dividends.

Yesterday Mr. Rohatyn testified before our committee. He suggested, as an alternative to find revenues, that we should perhaps look at taxing short-term capital gains. Is that something you would consider if we want to level the playing field?

Mr. GREENSPAN. When the 1986 Tax Reform Act was passed, the one aspect I felt uncomfortable with was the increase in the capital gains tax rate. I would very much not like to see it raised.

In fact, it would be preferable not to unwind the 1986 act by lowering the capital gains tax. So that I would not agree with Mr. Rohatyn on that issue, although I must say on a number of issues I find his views quite useful.

Mr. MATSUI. Would the increase in the capital gains tax for short-term transactions be warranted to deal with the leverage buyouts problem?

In comparison, what would be less harmful?

Mr. GREENSPAN. I am sure it would make a number of elements involved in leverage buyouts less profitable. But I would be concerned that while that might take some of the froth off the LBO boom, and I don't consider that bad, it would also create a lot of problems which may outweigh the advantages.

Mr. MATSUI. Assuming we want to level the playing field by allowing some deductibility of dividends, what would you suggest as the source of revenues that would do the least harm to the economy.

I realize it is a very broad question, but I think we may face that issue if we begin to mark up legislation.

Mr. GREENSPAN. Having looked at the LBO, and more generally the restructuring phenomenon, I concluded the major cause, not the sole cause, but the major cause has been the extraordinarily volatility of the American economy in the 1980's, which threw a number of corporate structures off kilter and created opportunities to make profits by putting them back together again in a more optimum fashion.

I suspect that we have already gone through a goodly part of the American economic structure that is susceptible to leveraged buyouts, and that we are probably not far from peaking in that process. So I am not strongly supportive of major actions taken for the sole purpose of undercutting that particular process.

Nonetheless, there is a major question with respect to the taxation of capital income which the LBO process has surfaced. It really has emphasized problems which occur as a consequence of double taxation of dividends.

That is something which I believe should be on this committee's agenda for the longer term, not necessarily a short-term fix, so to speak. Should the budget deficit problem be substantially resolved, I would bring that up on the agenda, but I would not put it ahead of solving the budget deficit.

To the extent it worsens the deficit, I would think it better to live for a while with the double taxation of dividends than try to resolve that at this stage. In any event, I don't think it is crucial to get to the LBO problem in the short term.

Mr. MATSUI. Are you saying there probably will not be many more LBO's, such as KKR of Nabisco?

Mr. GREENSPAN. I think there will be a considerable amount.

I just think that the whole thing has probably peaked. There is still a lot of it out there.

Mr. MATSUI. Is the reason we have not seen a lot of activity in the financial markets because we are holding these hearings? We began to discuss this matter in earnest around last September.

Are many of those involved in LBO's saying: let's sit back and wait while Congress gets over their frenzy?

Mr. GREENSPAN. I am sure that is the case. I am not looking at the period of the last 2 months and saying it slowed down, therefore, it must be over.

I was looking at more the underlying economic incentives to do it which I believe to be cresting.

Mr. RANGEL. The Chair recognizes Mr. Levin.

Mr. SANDER M. LEVIN. Thank you, Mr. Chairman.

Mr. Chairman, your nuances are so important that you state degrees very carefully.

Let me, if I might, ask you some bottom line, or discuss with you some bottom line questions.

I think Mr. Matsui's questions have kind of fleshed out your feeling about action by this committee on LBO's. You say on page 9, "All that doesn't mean that we should do nothing."

Then you immediately go on to say that, "One option that you might find attractive would cost a lot, and we don't have the money now."

So I think really what you are saying is all that doesn't mean that we should do nothing now. But I don't know that you are suggesting we do anything now.

Mr. GREENSPAN. It depends on whether you are looking at it from the point of view of the Ways and Means Committee or from the viewpoint of total government.

I do think that legislative initiatives at this are not terribly useful, at this stage because we don't have the money to correct the double taxation of dividends.

However, I do believe the supervisory authorities such as the Federal Reserve, have to look at LBO lending by the banks and that we have to review our processes of examination to make certain that we do not upend our banking system.

So I do believe that we, the Comptroller of Currency and the FDIC, have important responsibilities in the area of supervision.

Mr. SANDER M. LEVIN. Your bottom line response is that Congress should do nothing now, perhaps, later, if there is any action that should be done on the regulatory side? That seems a fair summary?

Mr. GREENSPAN. Yes, I would agree with that.

Mr. SANDER M. LEVIN. Because we need to in the end get advice where the nuances are clear. I respect that you tend to always speak in nuances.

Because every mole hill is a mountain in a sense when you speak; at least it could be.

Let me now turn to the other area we discussed. I thought Mr. Pease's questions and Mr. Russo's tended to flesh out where you were coming from.

It is my own view that when you minimize the differences on economic assumptions, that you very much diminish the chances for strong action here. So much of the argument relates to economic assumptions.

The history is that the administration and Congress have used economic assumptions which turned out to be false and which we knew going in were not likely to be true. We have used them not as an excuse for inaction, because we have done some things here, but clearly not enough.

I know that you need to be very cautious when you, for instance, criticize the longer term assumptions of the administration. You say you have your differences.

But when you diminish the significance of those differences, you really tend to move us toward less action. In a word, when you hedge, we tend to hold off. I think you know that.

The predictions are that we will be $10 billion off at least in terms of the present fiscal year. In terms of the longer range, the differences really aren't insignificant, are they?

Mr. GREENSPAN. We are dealing with an order of magnitude of a half a percent in real growth over the longer term, maybe slightly more, which is not a small number over the longer term.

Mr. Levin, I have been in the economic forecasting business for decades. When I was a private citizen that was my occupation. I am sufficiently aware of where the errors can emerge to know that.

For me to make a major difference in the short run of several tenths of a percentage point in real growth far exceeds my or anybody else's forecasting capability.

While I don't disagree that our hedging has the effect that you are suggesting, I cannot in all honesty argue strenuously that one forecast is right and one forecast is wrong when all of my history tells me that that is an exaggeration.

Mr. SANDER M. LEVIN. How about longer term? Do you feel the same about their longer terms?

Mr. **Greenspan**. As I said before, I think that the longer term forecast presupposes an increase in productivity which I find improbable.

Mr. **Sander** M. **Levin**. Your advice to us is to discount, if not disregard—I will use a more cautious word—discount the economic assumptions of the administration long term?

Mr. **Greenspan**. I am not saying they are outside the realm of credibility. They are in that range.

I just personally find their assumption of close to 2-percent annual productivity growth a less than 50/50 probability. I feel much more comfortable in projecting a lower number, which we have.

When I mentioned before the House Banking Committee that we believe the potential of the economy is in the longrun between 2½ and 3 percent, we have a number in there roughly a half a percentage point lower on long-term productivity than that in the Counsel of Economic Advisers report. Can they be right and we wrong?

The answer is, "Certainly". Do I think that is going to happen? No, no. If I did, I would change.

Mr. **Sander** M. **Levin**. Thank you.

Mr. **Rangel**. The Chair recognizes Mr. Moody.

Mr. **Moody**. Thank you.

I certainly want to join my colleagues in commending you on the job and the leadership you have been showing.

On the question of assumptions, clearly the administration and the CBO both can be said to have an ax to grind on these matters of forward projections.

The blue chip forecast is probably one which has no specific ax to grind. What strikes me is the enormous difference between the blue chip forecast and the administration forecast.

Here we are not talking about small one-half of a percentage point difference. For 1989 the administration is projecting 3.5-percent growth rate.

The blue chips are projecting 2.3 percent in real terms. That is an enormous difference for 1989.

For 1990, where, of course, information is tougher to forecast and less reliable, the differences are more dramatic—3.4 percent by the administration versus 1.9 percent by the blue chip.

We are not talking about small estimations of forecasting errors here. We are talking about enormous magnitudes of difference; 3.4 versus 1.9 is well beyond the kind of distinctions you are presenting to my colleague.

Let me move on and ask you to comment. The comparison, I think, is striking.

The CBO and the administration is 3.5 versus 2.9 for 1989. It is 3.4 for the administration versus 2.2 for the CBO. Those are bigger than the amounts you have been describing.

If I told you that a great nation was going to rapidly increase its growth rate from currently 2.6 to 3.5, and I told you at the same time that interest rates are going to sharply drop from their current level for 30-day rates down to 6.3, what would your reaction be to the internal consistency of that movement?

On the one hand we have a rapidly increasing rate of growth and on the other we have a sharp drop in the rate of interest.

Mr. GREENSPAN. Well, remember, Mr. Moody, that the Reagan forecast, as I indicated earlier, presupposes a very dramatic improvement in the Federal budget. In effect, it presupposes that the Congress will pass all of its budgetary requests in full.

As I have indicated here and I have indicated many times in the past, it is my expectation that should, in fact, the deficit be brought down dramatically and credibly, that interest rates will fall and fall quite appreciably.

Real interest rates currently are still well above what they were during most of the post World War II period. They would fall a good deal if economic conditions very significantly improve.

I don't find that the internal logic of their position as being erroneous. I might also add that while I feel uncomfortable with their 2 percent, near 2 percent increase in productivity over the long run, there is a certain validity in arguing that with a decline of the type that they are projecting or requesting, in the Federal budget, that it is possible that there would be a significant capital goods boom which could both add to the capacity and improve productivity. So it is not an internally inconsistent forecast.

It is based upon a projection of actions relative to the budget which I suspect in a whole set of private forecasters, the blue chip group, would not consider credible.

Mr. MOODY. Don't you think the private forecasters of blue chips assume somehow willy-nilly we were going to get down to the Gramm-Rudman level?

Mr. GREENSPAN. Not necessarily.

Mr. MOODY. The private sector must have assumed Gramm-Rudman would be met. That is what is so striking, the difference of private forecast of interest rates and the Reagan administration forecasts, although both must assume necessarily we met our Gramm-Rudman targets.

I don't know how you could possibly believe interest rates would fall to those levels—5.5 in 1990.

Mr. GREENSPAN. Well, I think that there are some who are concerned that the Congress will alter Gramm-Rudman-Hollings, alter the structure of the legislation and the goals if it gets too tough.

There is still a large degree of cynicism out there in the private sector. Although I must say it is somewhat diminished from what it was.

But I would argue that the range in the various different forecasts are still within what has historically occurred over a period of time. We look at forecasting accuracies, private economists, government, CEA, even the Federal research, the range of errors are somewhat disturbing to those of us who are in the forecasting profession.

Mr. MOODY. Thank you.

My time has expired.

Chairman ROSTENKOWSKI. Mr. Coyne.

Mr. COYNE. I have no questions.

Chairman ROSTENKOWSKI. Mr. Dorgan.

Mr. DORGAN. Thank you, Mr. Chairman.

Mr. Chairman, I would be remiss if I didn't just provide you with a perspective on the gas tax. I did intend to do that.

I want to remind you, coming from a Western State, that the imposition of an additional gas tax poses unfair burdens. A person who works with me comes from Brooklyn. She tells me when her family would go to visit relatives in Bayonne, it was a major trip. They would pack sandwiches, plan it for weeks, and finally visit Bayonne.

In North Dakota, after supper, people would travel 100 miles for a tractor part. We drive a lot more in North Dakota than citizens in New York.

If one suggests raising the gasoline tax as a way to reduce the deficit, one is really saying to those of us in the West, you should pay twice as much to reduce the deficit as those in the East.

I am sure you are aware of this discrimination and you understand the passion with which many of us raise these points in the context of deficit reduction.

Having listened to Secretary Brady and many other distinguished witnesses, including yourself, it is surprising to see the startling difference with which we view things.

Some of us believe that the mergers and LBO activity is an economic demolition derby. Others watch exactly the same thing and see it as a Sunday drive, and suggest there is not very much wrong.

My notion is that the economy is involved in wild speculation that is not good for this country's economy. Some of the testimony in the recent days has suggested that much of this wild speculation and increase in debt and hostile takeovers and so on, could not have occurred without the financial institutions participating in that type of leveraging.

Mr. Rohatyn, among others, has testified there has been a massive failure by regulatory agencies. You are undoubtedly familiar with terms such as junk bonds.

All of those are used by securities firms and investment houses. In the 1987 crash, Mr. Rohatyn testified yesterday that the Fed advised the banks to provide whatever liquidity was necessary to secure these houses during that crisis period.

His point was, therefore, the Fed has an interest in not only making sure there is an adequacy of capital for banks, but also security houses, based on what the Fed did in the 1987 crash.

If that is the case, one wonders if the Fed ought not be more mindful and concerned about what some of the security houses and investment bankers are doing in the area of debt. I would like you to comment on that perspective.

Mr. **Greenspan**. Without confirming or denying what it is we did or did not do in 1987 during the crash, obviously, we are most concerned about the total financial structure and its elements and the various difficulties that could or could not emerge.

The whole interest of the Federal Reserve is to see that financial system is sound and there is safe and sound banking, particularly. We, obviously, have been sensitive to the LBO problem for quite a while.

We have a whole series of examination guidelines from 1984. We have been looking at the process continuously since. The FDIC and the Office of Comptroller of the Currency have been looking very closely.

We are acutely aware of this process and what the dangers could be. I don't want to say to you that we don't care or that, in fact, there has been a supervisory glitch here because I don't think there has been.

I think that we have been sensitive to this issue and have been fairly close to it for a number of years.

Mr. DORGAN. I appreciate that answer.

Mr. Rohatyn testified—and my recollection was that the Fed was doing what was necessary to suggest that banks provide the liquidity necessary to overcome this crisis, the liquidity necessary——

Mr. GREENSPAN. I think that is not exactly the way I would put it nor exactly the way it was.

Mr. DORGAN. Could you tell us exactly the way it was?

Mr. GREENSPAN. What we did was stand ready to supply liquidity, but we are acutely aware of the fact that there are issues of safety and soundness in the banking system even during the period such as the immediate post crash period, and we clearly would not say to banks open up your window and let the cash flow out because that is not the way the system works, nor should it.

Mr. DORGAN. In that crisis you stood by to provide the liquidity. Investment banking houses are providing bridge loans which some testify are in excess of the capital structure of the investment houses themselves. Doesn't this cause you concern?

Mr. GREENSPAN. The liquidity that is involved here is supplying reserves for the banking system. That does not mean we stand ready to give loans to finance bridge loans of investment banking houses. That is not what we were preparing to do.

Our main concern during that period was the commercial banking system and the financial structure. It was not basically to open up the wallet of the Federal Reserve, so to speak, and finance everybody's loans, which we cannot, should not, and will not do.

Our major concern is the stability of the system, and we have a fairly systematic, calibrated means to achieve that. Hopefully, we do it in a manner as we did then, without in the process creating secondary consequences which we would have to live with.

Mr. DORGAN. Mr. Greenspan, I have studied and taught economics. One of the rudimentary lessons is the business cycle has both ups and downs and no one has been able to invent a substitute.

We have been in the throes of a business cycle which has been moving up for some time. I know you understand we will have an economic downturn. The question is when?

I wonder if all of what is going on today causes concern as to when that downturn occurs and its ramifications for the banking and securities industries?

Mr. GREENSPAN. We are aware of what would happen to this economy the next time it turns down. I don't believe the business cycle has been repealed.

We are going to have recessions in the future. As I said to the Joint Economic Committee, on Tuesday, at the moment the economy looks fairly stable. We cannot say at the moment that we see significant imbalances or that we are on the edge of a recession.

At some point something will go wrong. Either we will get speculative flurries of inventory investment or we will get different types of imbalances which will have to be corrected, and we will have a recession. I don't know when that will be.

Chairman **Rostenkowski**. Mr. Andrews.

Mr. **Andrews**. Thank you, Mr. Chairman.

Mr. Chairman, thank you for being so patient.

Your observations this morning have been very useful.

I would like to talk about the gasoline sales tax. Those of us from Western States—I am from Houston—are concerned about the disproportionate burden placed on Sunbelt States by that kind of tax. My good friend from New York, Tom Downey, I think brought it up today.

Since you didn't have an opportunity to respond to Mr. Dorgan's comment on the disproportionate leveling of that kind of tax, I wonder if you would do so now?

Mr. **Greenspan**. There is no question that the incidence of that tax does vary significantly with geography. As I said there is no such thing as a tax which is not harmful. You are indicating some of the harm that exists.

The crucial issue that I was raising is the difference between a tax or a fee, such as an import fee, which builds into the business cost structure of the economy, and a tax which does not. I would say that cost-raising taxes are the most deleterious form of taxation.

I fully sympathize with your concerns, which help explain why the gasoline tax in this country is so much lower than in other countries.

Nonetheless, the gasoline tax primarily affects final demand or final sales or consumption.

In other words, it is the tail end of the business process and does not get passed on into another layer or cost to the business sector. It is only in that sense that I am referring to it as a lesser evil.

Mr. **Andrews**. What would your thoughts be about other excise taxes, tobacco, beer, wine?

Mr. **Greenspan**. Remember——

Mr. **Andrews**. Similar view?

Mr. **Greenspan**. I myself am not advocating this because I think we would be far better off to do budget restriction from the expenditure side.

But, clearly, taxes differ. Clearly, an excise tax on something used in business will work its way through.

But a tax on tobacco clearly will not. That is a final consumption tax not dissimilar to the gasoline tax.

Mr. **Andrews**. Let me ask you to go back to your testimony. You made a comment that gave me pause. You suggested that if we dealt on the interest deduction side in trying to curtail LBO's, we may give an edge to foreign investors.

What are your thoughts about taking that kind of action as was suggested in the questions and answers the day before yesterday with the Secretary? What are your thoughts about our international trading partners, specifically those trading partners along the Pacific Rim? Would we not put ourselves at a disadvantage if we capped in some way interest deductions?

Mr. **Greenspan**. We are at a disadvantage now. The Japanese and others already have a lower cost of capital than ours. Were we to cap interest deductibility, I think we would widen the gap to our disadvantage.

Mr. ANDREWS. Thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. Ford.

Mr. FORD. Thank you, Mr. Chairman.

Mr. Greenspan, to pick up where my colleague just left off, he talked about the enormous interest rates on the deductions of the claims for most LBO's.

In addition, the accompanying bank debt increases, the money supply as commercial banks present those notes to the Federal Reserve for rediscounting. My question is, Which of these do you consider the most desirable results, for those deductions to operate to enrich a few managers and takeover special interests or to also finance a capital estate for employees of a company who must work to generate the revenue to repay that debt, or does it matter?

I guess I am referring to employees stock ownership. I have heard a lot of talk about the acquisition and leverage buyouts, but little talk about the employees stock ownership when we talk about these LBO's.

Mr. GREENSPAN. I am sorry. I am not quite sure I understand your question, Mr. Ford.

Mr. FORD. Basically, we are talking about these LBO's in a sense that employee stock ownership or employees have not participated in at all.

When we look, and think in terms of these enormous interest deductions that are being taken by the LBO's, what is your position as it relates to employees stock ownership being a part of the LBO's?

Mr. GREENSPAN. Well, I support the broadest corporate ownership that we can get.

To the extent that employees have a significant stake in the companies for whom they work, that is all to the good. I think that anything that can be done to enhance that is desirable.

LBO's and the very large fees which you noted, are a consequence of a highly unstable economic environment that occurred in the early part of the 1980's. That environment made a number of previously optimally structured companies less desirable.

Throwing these companies off kilter created a very significant amount of potential profitability from restructuring. The result of that is very large fees. Very large amounts of money are involved and fees are correspondingly large. But fees are only a sympton of a more deep-seated problem, caused by the instability of the system.

The best way to handle that without creating secondary consequences is to try to get back to a more stable, more sensible, economic environment in which we do not get the high degree of instability and the required restructures involved with it.

So rather than look at the symptoms of the problem, and these are symptoms, I would frankly tend to look at the more deep-seated causes and recognize that if we try to solve the symptoms we are going to miss the deep-seated causes. So I would say that at the moment, it is probably not sensible to engage in a major legislative agenda to resolve this question, especially since I suspect LBO's may already have peaked.

Mr. **Ford**. But currently the specialists and managers are those who rake in the profits. Under the employee stock ownership it is broadening that field of employees who will have to work hard to repay down this huge debt that has been built up.

Mr. **Greenspan**. Let me amend my earlier remarks. In innumerable cases employee-owned stock has gone up very appreciably in these buyouts, and employees have considerably benefited. More generally, to the extent that these stocks are held in pension funds employees have benefited indirectly.

So it is not as though one small group has benefited at the expense of everybody else. On the contrary, there have been, as I said in my remarks, up to half a trillion dollars in profits as a consequence of the restructuring since 1982. And pension funds have benefited very appreciably from that, as have ESOP's, although I certainly grant you it looks as though benefits are unequally shared.

Mr. **Ford**. Do you think it is healthy for the economy with so few people sharing in these LBO's?

Mr. **Greenspan**. I don't think it is healthy for an economy to be heavily distorted by high real interest rates, by very highly unstable inflationary pressures. I think the restructurings that have occurred, and specifically the leveraged buyout part of the restructuring, is a response to that significant distortion. I don't deny that in the process of trying to put the thing back right, one sees inequities occurring, and I probably would agree with you in part, and I would have my own concerns about what inequities I see.

But I think those are the symptoms of the more deep-seated problem, and I would not be inclined to try to solve them directly but would rather address the underlying problems that cause the restructurings themselves.

Mr. **Ford**. Thank you very much.

Chairman **Rostenkowski**. I believe that we have exhausted the questions, Mr. Chairman. Thank you very much for joining us. You have been a tremendous help. I want you to know how much we on the committee appreciate the fact that you participated in this discussion. We look forward to having many more meetings with you, Mr. Chairman. Thank you.

Mr. **Greenspan**. Thank you very much, Mr. Chairman. I look forward to my next invitation.

[The following questions from Congressman Coyne, and responses, were subsequently received:]

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

ALAN GREENSPAN
CHAIRMAN

March 3, 1989

The Honorable Dan Rostenkowski
Chairman
Committee on Ways and Means
House of Representatives
Washington, D.C. 20515

Dear Mr. Chairman:

Thank you for your letter of February 21 enclosing written questions in connection with the hearing held on February 2 on Tax Policy Aspects of Mergers and Acquisitions. I am pleased to enclose my responses to the questions for inclusion in the record of the hearing.

I hope this information is useful. Please let me know if I can be of further assistance.

Sincerely,

Alan Greenspan

Enclosures

Chairman Greenspan subsequently submitted the following in response to written questions from Congressman Coyne in connection with the hearing held on February 2, 1989:

Question 1: Your testimony says that the Fed has "cautioned banks...that they should make certain that they examine the prospects for LBO loans under a range of economic and financial circumstances." Under what circumstances would the Fed exercise its regulatory authority beyond issuing cautions?

Answer: Federal Reserve examiners review the internal policies, systems and controls, as well as the asset quality, of state member banks and bank holding companies engaged in LBOs and other highly leveraged financings (HLFs). A copy of the Federal Reserve's recently revised examination guidelines is attached.

In general, the Federal Reserve expects organizations engaged in these activities to have internal policies, systems, and controls that are adequate in light of the potential risks associated with HLFs. Prudent policies and procedures would normally include reasonable "in-house" exposure limits; credit review and approval procedures that take account of the potential effects of a change in the general level of economic activity, the borrower's financial performance, or interest rates, on the borrower's cash flow and collateral values; effective internal tracking and reporting systems for senior management and the directors; and procedures for ensuring that all related fees are properly recognized.

In addition to evaluating a lender's internal policies and systems, examiners are also instructed to evaluate the quality of the institution's loan portfolio, including the status and condition of its HLF exposures. Loans that involve excessive risks, or loans where repayment is based upon inadequate cash flow or the speculative sale of assets, would be criticized by examiners. Moreover, excessive concentrations of loans to particular industrial sectors, or undue concentrations that would be adversely affected by common economic developments, would also be brought to the attention of management.

Banking organizations are expected to address and correct significant deficiencies in any of these areas. The banking agencies have an array of supervisory tools to deal with these matters ranging from meetings with management and directors to formal administrative enforcement actions, including the issuance of cease and desist orders. Organizations whose loans are considered to entail higher than normal risks would be expected to establish adequate loan loss reserves and strengthen their internal credit review and approval procedures. In addition, such organizations would be required to develop and implement plans to increase their capital positions to levels that are considered adequate in light of the overall quality of their loan portfolios.

Question 2: According to the New York Times, you said that the Fed's analysis of the LBO situation "would lend [you] to do very little with respect to legislation but a lot with respect to supervision, especially in the banking area." What can Congress do to insure that the appropriate amount of supervision is taking place?

Answer: The response to question 1 and the attached HLF examination guidelines set forth some of the steps the Federal Reserve has taken to strengthen supervision regarding LBOs and HLFs. Obviously Congress, too, plays an extremely important role in assuring an adequate level of supervision and regulation of our nation's financial institutions, particularly in the conduct of its legislative and oversight functions and by encouraging and supporting initiatives of the banking agencies to strengthen, where necessary, the basic supervisory framework. In the past, Congress has supported supervisory efforts to require banking organizations to strengthen their capital positions in order to enhance the soundness of individual institutions and promote the stability of the banking system. Through its oversight activities and hearings on important issues, such as LBOs, the Congress has also helped to focus attention on developments that could have significant implications for the condition of our financial system. Such activities, as well as efforts to ensure that the banking agencies have adequate resources to address important supervisory issues, are essential to maintaining an effective supervisory framework.

Congress also will play an important role in reviewing and approving the President's plan for the reform and recovery of the thrift industry. In addition to effectively addressing the serious problems in the thrift industry, the proposed legislation will also help to strengthen depository institutions more generally and enhance the supervisory agencies' regulatory and enforcement authority. Moreover, we continue to believe that the Congress should act to broaden the securities powers of banking organizations by repealing the Glass-Steagall Act's separation of investment and commercial banking within the context of the strengthened prudential framework and "firewalls" long advocated by the Federal Reserve Board. This will enhance banks' competitive positions, result in important benefits to users of bank services, and, at the same time, insulate the bank and the Federal safety net from any additional risks involved.

Question 3: Over the past six months, it has been reported that the Federal Reserve Board believes the nation is currently at the non-accelerating inflation rate of unemployment and that we're close to the maximum level of production with respect to capital. It is expected that you will tighten up the money supply to slow down the growth rate. This should have the effect of increasing the interest rate. As you know, a number of LBOs are financed with short-term loans with interest rates that can be renegotiated. When the Fed makes its decision on monetary policy, will you take into consideration the impact of higher interest rates on corporate debt?

Answer: The Federal Reserve recognized that some business firms that have been involved in LBOs, mergers, or other restructurings, as well as some other borrowers, may well experience financial stress owing to the interaction of relatively high debt ratios with rising short-term interest rates, should such an increase occur. The Federal Reserve is concerned about the implications of such stress for the overall health of the economy and financial markets, and takes account of such developments in formulating monetary policy. That policy, however, must be keyed to our broad economic goals of sustainable economic growth and reasonable price stability, rather than to the needs of particular borrowing sectors. By pursuing policies designed to foster reasonable price stability, the Federal Reserve is putting into place conditions that should encourage lower interest rates, a more stable financial system, and sustainable economic growth over the long run. Lower interest rates would also be promoted by a fiscal policy designed to reduce the federal budget deficit and thereby increase national saving.

Question 4: We've been told by the Congressional Budget Office that a one percentage-point increase in the interest rate will increase service on the national debt by $10 billion. Can you estimate for us what impact a one percentage-point increase in the prime rate would have on corporate debt service?

Answer: There is no precise, all purpose answer that can be given to your question. Clearly, a higher prime rate does tend to raise corporate debt service, but the amount will depend on innumerable factors. Corporations finance themselves through many different channels, including many fixed-rate vehicles. Over any time span the response of debt service costs to a change in rates will depend on the full structure of debt obligations and how that may change in reaction to rate movements. (It should be noted that many firms also hold sizeable amounts of financial assets, which implies another effect of changing interest rates on corporate cash flow.) Lacking the detailed information on private debt that we have for Treasury debt, we really can't make the same sort of estimate for corporations, even on a "static" basis, that we can for the government. Moreover, to get at the vulnerability of firms to rising debt costs, as your other questions suggest, one would want to focus on the issue at a disaggregated level.

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

DIVISION OF BANKING
SUPERVISION AND REGULATION

February 16, 1989

TO THE OFFICER IN CHARGE OF SUPERVISION
AT EACH FEDERAL RESERVE BANK

SUBJECT: Highly Leveraged Financings

Highly leveraged financings (HLFs), including leveraged buyouts, have become an increasingly important and prevalent technique for financing acquisitions and for other purposes. Participation of banking organizations in such activities is not considered inappropriate so long as it is conducted in a sound and prudent manner. However, the involvement of banking organizations, including commercial banks and their holding company affiliates, in highly leveraged financing arrangements may have significant implications for the quality of their asset portfolios and their overall levels of risk exposure.

HLFs involve many of the same characteristics and risks that have traditionally been evaluated by supervisors during on-site examinations. These relate to the borrower's income, cash flow, and general ability to pay interest and principal on outstanding debt, economic conditions and trends, the individual borrower's future prospects, the quality and continuity of the borrower's management, and the borrower's ability to realize value through the sale or liquidation of assets. What usually distinguishes HLFs from typical bank loans is the level of debt the borrower assumes in relation to standard measures of financial capacity or ability to repay. Clearly, a high level of debt in relation to net worth or total assets can place heavy demands on a borrower's cash flow and reduce the borrower's ability to absorb the effects of unanticipated financial shocks or economic adversity.

Banking organizations participate in HLFs at a number of levels. First, banks, together with other institutional lenders, may provide senior secured financing that typically represents the largest portion of an HLF. In addition, banks, bank holding companies and/or their nonbank subsidiaries may take equity positions or extend credit on a subordinated basis (mezzanine financing). Bridge loans represent one type of subordinated financing that is generally unsecured and depends on the successful marketing of longer term securities or the sale of assets for repayment. Finally, bank holding companies may invest in LBO funds that are managed by investment banking companies or other third parties.

To the extent that high leverage increases the vulnerability of borrowers to adverse market and financial developments, HLFs have the potential to raise the level of risk in bank loan portfolios. For these reasons, the Federal Reserve has actively urged bank management to exercise caution and apply especially rigorous lending and investing standards in participating in LBOs and other highly leveraged transactions.

In general, banking organizations involved in HLFs are expected to i) evaluate the adequacy and stability of the borrower's current and prospective cash flow under varying economic scenarios, including the possibility of an economic decline; ii) set reasonable "in-house" limits on a consolidated holding company basis regarding exposure to individual borrowers, total exposure to all HLF borrowers, and industry concentrations resulting from HLFs; iii) establish credit analysis, approval and review procedures that take account of the high levels of debt involved in these transactions; iv) maintain internal systems, controls and reporting procedures that track the performance and condition of individual exposures, monitor the organization's compliance with internal procedures and limits, and keep senior management and the directors adequately informed on a timely basis of the organization's involvement in HLFs; v) establish pricing policies and practices that take account in a prudent manner of the tradeoff between risk and return; and vi) avoid compromising sound banking practices in an effort to broaden market share or realize substantial fees.

Banking organizations should establish appropriate policies, procedures and controls before becoming involved in HLFs. In addition, significant policies and procedures, including internal lending limits and credit review and approval procedures, should be approved and reviewed periodically by the organization's board of directors.

Bank holding company HLF exposures should be monitored on a consolidated basis and should take account of loans and holdings of debt and equity securities issued in connection with HLFs, as well as any ordinary business loans to the same obligor. In addition, each holding company subsidiary participating in a HLF should establish reasonable exposure limits and appropriate credit review and approval procedures that call for an independent appraisal of the loan or investment. In particular, banks making loans to borrowers whose obligations are being underwritten by securities affiliates have an obligation to make a complete and "arms-length" assessment of the credit risks in accordance with the provisions spelled out in the Board's Section 20 orders.

Banking organizations purchasing participations in HLFs originated by other firms have the responsibility to make their own thorough and independent evaluation of the transaction and the risks involved before advancing any funds. Once the participation is purchased, such organizations should carefully monitor the borrower's performance throughout the life of the loan. All institutions engaged in highly leveraged financing transactions must assure that related fees and commissions are accounted for in accordance with generally accepted accounting principles. Finally, banking institutions engaged in these transactions should maintain loan loss reserves and capital positions that are fully adequate, given the nature and composition of their HLF portfolios, as well as their exposures to any other borrowers with significant leverage.

In view of the recent increase in the volume and size of LBOs and other restructuring transactions, HLFs continue to warrant the close attention of bank and holding company managers and directors. Such transactions should also continue to be carefully reviewed during on-site examinations and inspections. This is particularly important since the performance of these loans generally has not yet been tested in a period of economic decline. Any significant portfolio risks need to be identified and brought to the attention of senior management and the directors. In addition, any weaknesses in lending and underwriting standards or practices, or deficiencies in internal review, approval and control mechanisms, need to be addressed.

In the course of on-site examinations of banks and bank holding companies, examiners should review the organization's overall involvement in HLFs, as well as the individual loans and other forms of exposure associated with these transactions. The attachment to this letter sets forth general examination guidelines intended to underscore and supplement existing loan review procedures. Significant deficiencies or risks regarding a banking organization's HLFs should be discussed on page one of the examination report and brought to the attention of the board of directors.

The general criteria for identifying HLFs for examination purposes are set forth in the attached examination guidelines. In brief, HLFs are defined as exposures that meet two conditions. First, the exposures comprise loans and other claims assumed in connection with corporate restructurings, such as leveraged buyouts and similar transactions and corporate acquisitions or mergers funded with borrowed money. The definition also includes significant stock buybacks and cash dividends funded with debt. Second, HLFs are deemed to involve loans and other exposures to borrowers whose total debt-to-total assets ratios exceed 75 percent. In addition to this general leverage criterion, examiners may also consider the norms and standards for leverage in particular industries, as well as the cash flow-to-debt service coverage in individual transactions in determining what constitutes an HLF.

It is important to stress that these criteria are general guidelines. They are not meant to imply criticism of any particular transaction, nor to suggest what is deemed to be an appropriate degree of leverage in any particular industry.

Rather, the guidelines represent an additional tool to assist examiners in identifying in the first instance exposures that may warrant closer scrutiny. Any criticisms of specific transactions should be based upon an in-depth evaluation of all of the factors *affecting the quality of the exposure*, including the adequacy of the borrower's earnings, cash flow and collateral, as well as the quality of the borrower's financial, managerial and operating performance.

The attached guidelines, which supersede the Federal Reserve's SR letter on leveraged buyouts dated June 7, 1984, may be revised or refined in the future in light of changing conditions or practices within the banking industry.

William Taylor

William Taylor
Staff Director

Attachment

Attachment

EXAMINATION GUIDELINES REGARDING HIGHLY LEVERAGED FINANCING TRANSACTIONS

General comments regarding the definition of HLFs

- Examiners should review an organization's internal definition of HLFs to determine whether it reflects the risk factors associated with these transactions.
- For purposes of assessing an organization's HLF activities in examination and inspection reports, HLFs are defined as exposures that meet both of the following two conditions: First, credit is extended in connection with an acquisition by, or a restructuring of, the organization. Typically, such credits are extended to enable the employees, management, directors, or outside investors, acting individually or jointly, to gain effective control of an organization through the purchase of stock and/or acquisition of assets. Thus, the definition includes leveraged buyouts and similar transactions, as well as corporate mergers and acquisitions funded by debt. Significant company buybacks of stock and large cash dividends financed through borrowings may also be included. Second, the extension of credit results in "high leverage" or is made to an already highly leveraged organization. As a general guideline, high leverage is defined for this purpose as a total debt-to-total assets ratio exceeding 75 percent. In addition to this leverage benchmark, examiners may also take account of the norms and standards for leverage in a particular industry as well as the cash flow-to-debt service coverage for a particular transaction in determining what constitutes an HLF.
- Total exposure to individual HLF borrowers includes all loans, extensions of credit, and debt and equity securities relating to acquisitions or restructuring transactions, as well as any ordinary business loans to, or investments in, the same obligor. Total exposure also includes standby letters of credit, legally binding contractual commitments, and other financial guarantees.
- Loans or exposures to any obligor in which the total financing package (including extensions of credit by all participants) did not exceed $5 million at the time of origination may be excluded from the definition of HLFs.
- These guidelines are not meant to suggest that loans or exposures meeting the HLF definition should necessarily be criticized or deemed to involve excessive risks. Nor is the 75 percent debt-to-assets benchmark intended to reflect what is considered high or abnormal leverage in all industries. Rather, the definition is intended to provide guidance to examiners for identifying in the first

instance certain exposures that may warrant further scrutiny and to do so on a consistent basis across banking organizations. The analysis of a borrower's financial position should take account of both the absolute level of the borrower's leverage ratio, as well as how the borrower's leverage compares to conditions and norms within the particular industry. Any criticism of exposures stemming from HLFs, like all other credits, should be based on the examiner's evaluation of all relevant credit factors, as well as on the guidelines set forth below.

Policies and procedures

- Examiners should review an organization's policies and procedures to ensure that: i) credit evaluation involves an independent assessment of the adequacy of the borrower's current cash flow and collateral values and the projected values under varying economic and interest rate assumptions, including the possibility of an economic decline; ii) the organization has established reasonable "in-house" limits regarding exposure to individual borrowers, total exposure to all HLF borrowers, and industry concentrations; iii) credit decisions on significant HLFs are made and monitored at appropriate senior management levels; iv) management reporting systems and controls are adequate to monitor the condition of individual HLF borrowers, as well as the organization's compliance with internal policies and lending limits; and v) timely and adequate reports are provided to senior management and boards of directors regarding the performance of significant HLF exposures and the organization's overall involvement in this activity.

- Credit standards and pricing policies should be reviewed to determine that they incorporate consideration of the tradeoff between risk and return.

- Each holding company subsidiary should establish appropriate credit review and approval procedures that call for a complete and independent assessment of loans or investments to be made by the subsidiary. Review and approval standards regarding mezzanine financing and equity positions should take account of the particular risks associated with these activities.

- "In-house" limits should be based on consolidated holding company exposure and take account of all extensions of credit, as well as holdings of debt and equity securities issued by HLF obligors. In addition, appropriate exposure limits should also be established for each subsidiary engaged in any aspect of an HLF. When a single HLF transaction involves loans or exposures to legally separate but related obligors, the exposures should be combined for determining compliance with internal exposure limits.

- Examiners should review the banking organization's internal guidelines or practices on what is considered to be an acceptable minimum level of: i) borrower cash flow in relation to debt service and fixed charge requirements; and ii) collateral protection.

- A banking organization's internal credit review and approval procedures should call for an evaluation of the continuity and experience of the borrower's management.

- Examiners should determine that all income, fees and commissions relating to HLFs are properly identified and recognized in accordance with generally accepted accounting principles. Internal reporting systems should monitor the amount and treatment of fees associated with HLFs.

- Examiners should ascertain whether banking organizations purchasing participations in HLFs apply the same standards of prudence, credit assessment and approval criteria, and "in-house" limits that would be employed if the purchasing organization were originating the loan. Examiners should also ensure that the purchasing institution obtains from the lead lender copies of all executed or proposed loan documents, legal opinions, title insurance policies, UCC searches and other relevant documents. The purchase of participations in HLFs originated by other banks should involve a full and independent credit review by the purchasing organization. Organizations holding participations should obtain adequate and timely information on the borrower and closely monitor the borrower's performance throughout the entire life of the exposure.

- Sales of participations in HLFs should be made on a non-recourse basis. Approval procedures and exposure or position limits should apply to any purchases of HLF loans as part of trading or market-making activities. Such purchases should be segregated in a separate trading account and be reported at the current market value, or the lower of cost or market value.

- A banking organization's policies and procedures should provide for legal review of involvement in HLFs to determine that the activities are consistent with applicable laws and regulations and that they are conducted in a manner that addresses the potential for conflicts of interest. Policies and procedures regarding loans to borrowers whose obligations are being underwritten by an affiliated securities firm should be carefully reviewed to determine compliance with the prudential framework set forth in the Board's Section 20 orders. Among other things, this framework requires the banking organization to establish appropriate limits for the consolidated holding company's overall exposure to any single underwriting client of a securities affiliate. Policies should also address the risks associated with equitable subordination. Examiners should determine whether the banking organization has a comprehensive documentation policy addressing the primary legal risk of fraudulent conveyance in LBO transactions.

- Major policies and procedures, including internal credit review and approval procedures and "in-house" exposure limits, should be reviewed periodically and approved by the board of directors.

Other examination considerations

- In evaluating individual loans and credit files, particular attention should be addressed to i) the overall performance and profitability of the industry over time, including during periods of economic or financial adversity; ii) the history and stability of the borrower's market share, earnings and cash flow, particularly over the most recent business cycle and the last economic downturn; iii) the reasonableness of earnings and cash flow projections; iv) the relationship between the borrowing company's projected cash flow and debt service requirements and the resulting margin of debt service coverage; and v) the reliability and stability of collateral values, including their sensitivity to varying economic scenarios, and the adequacy of collateral coverage.

- Particular attention should be paid to the adequacy of a borrower's cash flow. Banking organizations should make an independent and realistic assessment of the borrower's cash flow projections under varying economic and interest rate assumptions and be able to demonstrate that they have taken into account the potential effects of an economic downturn on a borrower's cash flow and collateral values before becoming involved in an HLF.

- A loan whose repayment is not predicated upon an identifiable and historically stable source of cash flow bears speculative qualities. Reliance for loan repayment on the sale of assets or subsidiaries whose values are not clearly supported by i) an historically demonstrated ability to produce adequate cash flow, ii) a firm sales contract or "take-out" commitment, or iii) a realistic cash-generating capacity based upon current economic conditions, is an inappropriate banking practice that could expose a bank to undue risks. Such loans should receive careful supervisory scrutiny and, under normal circumstances, should be subject to examiner comment or criticism. Ordinarily, unless conservatively projected cash inflows provide a reasonable margin above the total debt service requirements and other fixed expenditures of the borrower, classification of the credit is appropriate.

- When the proceeds of asset sales play an important role in reducing the debt, the methods used to determine asset valuations and projected sale proceeds should be carefully scrutinized. In addition, asset collateral coverage should be reassessed periodically throughout the life of the debt, and actual sales proceeds should be compared to projections made at origination of the HLF in order to monitor the reasonableness of the lender's assumptions concerning valuations.

- Repayment programs should specify the sources and timing of repayment, and any significant deviations from the programs should be evaluated.

- The amount of senior debt in relation to total financing should be carefully reviewed. In general, a bank's risk can be reduced if its position is senior to all other levels of debt and secured by a first lien on assets or all the stock of the borrower's operating entities. Ideally, the debt structure should permit the borrower to suspend payments on junior debt should circumstances so warrant.

- Special attention should be given to the risks associated with short-term bridge financing in connection with highly-leveraged restructurings. Such risks may be greater than normal because these loans are typically subordinated to other debt, may not be collateralized, and depend on the successful marketing of longer term securities or the sale of assets for repayment.

- Because of potential conflicts of interest that may affect lending practices, examiners should carefully review any loans and related documentation involving borrowers whose obligations are being underwritten by a securities affiliate.

- Examiners should determine the extent to which borrowers are protected from interest rate increases via interest rate caps or other hedging mechanisms. Generally, long-term loans to HLF obligors should involve some measure of protection for the borrower against increases in interest rates.

- In addition to reviewing the total volume of a banking organization's HLFs, examiners should assess the extent to which the organization's income comprises fees and commissions relating to HLFs. Examiners should also take account of the extent to which income is composed of gains on the sale of equity holdings.

- In addition to equity positions relating to particular HLFs, examiners should determine the extent of the banking organization's involvement in LBO funds.

- Examiners should review the timeliness and quality of reports to senior management and directors. Reports should address the performance of HLF obligors, the quality of the HLF portfolio, and the condition of the organization's overall HLF activities.

- Total HLF exposure should be treated as a potential concentration of credit and if, in the aggregate, it is sufficiently large in relation to capital, the total HLF exposure and a listing of the major HLF obligors should be included on the concentrations page in the examination report. A brief comment should describe the composition of these exposures (i.e., breakdown by number, outstandings, unused commitments, industry involvement, type and level of total criticized).

- If HLFs are not considered to be a concentration of credit, but are still considered a significant activity, the total exposure and the other information described in the previous item should be set forth in the confidential section of the examination or inspection report.

TESTIMONY OF THE COALITION ON SMOKING OR HEALTH
AMERICAN CANCER SOCIETY
AMERICAN LUNG ASSOCIATION
AMERICAN HEART ASSOCIATION

The Coalition on Smoking OR Health, comprised of the American Cancer Society, the American Heart Association, and American Lung Association, welcomes this opportunity to submit testimony on deficit reduction alternatives. The Coalition strongly urges the Congress to enact a substantial increase in the Federal cigarette excise tax. While the Coalition's support for a cigarette excise tax increase relates primarily to the causal relationship between higher cigarette prices and lower cigarette consumption, particularly among young people, we have examined the increase within the context of its revenue raising potential as well. A 25 cent increase in the Federal excise tax would increase the tax to 41 cents per pack, and taking into account any decrease in cigarette consumption which would occur, this tax would raise nearly $4.5 billion in revenue annually.

The adverse health effects related to cigarette consumption are indisputable. According to the Surgeon General's most recent report, nearly 400,000 persons die annually from smoking-related deaths. Specific smoking-related illnesses are worth noting:

- Cancer due to smoking is the greatest cause of smoking-related death in the U.S., accounting for more than 137,000 deaths in 1985. According to the 1989 Surgeon General's report, smoking accounted for 87 percent of lung cancer deaths. Lung cancer has surpassed breast cancer as the main cancer killer of women.

- Cardiovascular disease is the second most prevalent cause of smoking-related mortality in the U.S., accounting for 115,000 deaths in 1985. Smokers have more than twice the risk of heart attack as nonsmokers.

- Chronic obstructive lung disease (COLD) is the fifth leading cause of death in the U.S. Cigarette smoking causes up to 90 percent of all cases of COLD in the U.S., killing 57,000 Americans in 1985.

The support for a cigarette tax increase by the American Cancer Society, American Heart Association, and American Lung Association is based first and foremost on the well-founded fact that significant health benefits will directly result from a tax increase. These health benefits have been most clearly enunciated by University of Michigan economist Kenneth E. Warner. In a 1985 analysis, Warner concluded that a doubling of the current Federal cigarette excise tax (raising the tax from 16 cents to 32 cents per pack of cigarettes) "would encourage almost 3.5 million Americans to forego smoking habits in which they would engage if the tax were to remain at 16 cents per pack. This figure includes more than 800,000 teenagers and almost 2 million young adults aged 20 to 35 years who would either quit or decide not to become addicted."

A cigarette excise tax increase is broadly supported by many national organizations, including the American Medical Association, the American Public Health Association, the Children's Defense Fund, and the National Council on Aging. Polling data further demonstrate that an excise tax increase is the most favored deficit reduction alternative of the American people:

- According to a February 1984 poll conducted for TIME, when asked, "To reduce the size of the federal deficit, are you willing to see the Government raise taxes on tobacco," 77 percent of respondents indicated they were willing to see such taxes increased.

- According to a March 1986 poll conducted for the L.A. Times, when asked, "Would you favor one of the following revenue hikes or would you rather consider some other way to raise money for the Government instead," 81 percent of respondents indicated they favor higher taxes on liquor and cigarettes.

- According to a 1987 Washington Post-ABC News poll, when pollsters stated, "I am going to mention some things that have been proposed to help balance the federal budget, and for each, please tell me whether you approved or disapprove of that proposal," 75 percent of respondents indicated they approved raising taxes on liquor, beer, and cigarettes.

- According to a 1988 Media General-Associated Press poll, "More than 7 in 10... approve of higher cigarette and alcoholic beverage taxes."

- The Council on Competitiveness, comprised of 157 chief executives from business, labor, and higher education, has also called for an increase in the Federal cigarette excise tax, noting that "the effective tax rate[] on cigarettes... has deteriorated significantly as a result of inflation."

A cigarette excise tax increase is also justified as a means of offsetting the direct and immediate economic costs of tobacco use in the United States. In 1985, the Office of Technology Assessment (OTA) found that our nation incurs an estimated $65 billion yearly in smoking-related health care and lost productivity costs. An estimated $22 billion annually in smoking-related health care costs alone were cited. This figure represented approximately six percent of the Gross National Product (GNP). An estimated 75 percent of these costs were believed to be incurred by those under age 65. Annual lost productivity costs, including smoking-related absenteeism and disability, were estimated at $43 billion.

The Federal government bears the burden for covering many of these costs. According to OTA, annual Federal government smoking-related health care outlays included an estimated $4.2 billion in Medicare and Medicaid payments. Other Federal government outlays included an estimated $210 million through the Department of Defense and $400 million by the Veterans Administration.

In calculating the costs to government programs, OTA included only costs to programs that provide personal health care for those persons aged 65 and over. Excluded were expenditures through the Medicare and Medicaid programs for medical treatment to those under the age of 65, and all costs to social security disability insurance and other government programs which provide income support for some persons unable to work due to smoking-related disease. Thus, the OTA analysis is understated, and the actual costs to the Federal government due to smoking-related illnesses probably exceeds the $4 billion figure. In fact, other analyses have suggested that the Federal government's smoking-related health care costs may well exceed $6 billion annually.

The OTA analysis supports the conclusion that cigarette consumption contributes directly to this nation's federal deficit by increasing health care outlays and through lost productivity. Thus, to the extent that the tobacco industry should bear some responsibility for increased government health care expenditures, the cigarette excise tax represents a "user fee." The Coalition supports this contention and maintains that cigarettes are unique and distinct from all other consumer products, in that cigarettes are the only consumer product that can kill when used precisely as intended.

The Federal government incurs additional costs related to cigarette consumption. For example, the cost of the U.S. Department of Agriculture's Tobacco Price Support and Loan Program was $279.2 million last year. In previous years--1986 and 1985--the costs were $159.7 million and $80.0 million, respectively. Recent expenditures thus contrast strikingly with the $65.9 million spent by the Federal government for all tobacco loan principal losses from 1933 - 1984.

As another example, the tobacco industry spends $2.5 billion annually in advertising and promoting its product. A portion of these expenditures is deducted as business expenses. The allowance of this deduction amounts to a government subsidy of over $700 million a year, or approximately $2.3 billion to the manufacturers over the next three years.

Many argue against excise tax increases suggesting that such taxes are regressive in nature. We firmly maintain that there is nothing more regressive than the financial costs that accrue from smoking-related illnesses.

We further contend that to the extent recent cigarette price increases have placed a burden on certain segments of our society, the fault lies with the tobacco industry and not with the government. The industry has continuously raised prices far in excess of inflation. Since January 1980 alone, this country's six major cigarette manufacturers have, in unison, raised prices 20 times. Retail prices of tobacco products were nine percent higher this past July than just a year earlier, with the manufacturers raising prices in December 1987, and again in June 1988. (This rate of cigarette price increases has far outpaced the price rate increase experienced by other consumer goods.) The June 1988 increase raised the price of a single carton of cigarettes by 40 cents for non-generics, by 50 cents for branded generics and by 55 cents for generics.

These increases will result in an increase in revenues to the industry of over $1 billion for the six major tobacco companies. This pattern of collusive price raising has been consistent over the years, and guarantees a continuing comfortable profit margin for the industry.

It is these price increases, and not government excise tax increases, which should be recognized as posing any purported hardship on consumers.

A substantial increase in the Federal cigarette excise tax will discourage cigarette smoking, which is described by the Surgeon General as the single most preventable cause of death. Moreover, an increase will raise significant revenues, which may be used to offset or cover the health care costs related to smoking.

The American Cancer Society, American Heart Association, and the American Lung Association, acting jointly as the Coalition on Smoking OR Health, maintain that a substantial cigarette excise tax increase represents sound health care and sound economic policy. We urge Congress to enact such an increase.

February 17, 1989
P. O. Box 158
Alstead, N.H. 03602

Mr. Robert J. Leonard, Chief Counsel
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Mr. Leonard,

I am enclosing my statement and accompanying documents in support of a gas tax increase with specific allocations of part of it for deficit reduction, economic improvement in our industries, reduction in our trade deficit and for a major improvement in our environment.

This material is sent in response to your Press Release #31.

Sincerely,

Samuel E Stokes Jr.
Samuel E. Stokes Jr.

encl.

FOR A FAIR AND BALANCED TRANSPORTATION SYSTEM

With "Frenzied Skies" above us, according to *Business Week* and with "Gridlock" around us, according to *Time*, it is urgent that we rebuild our railroad system.

Environmentalists are concerned about the deforestation of large areas of the world and the subsequent desertification of former lush areas. In this country some would build hundreds of new airports and highways to relieve the crowding. To cover thousands of more acres with asphalt is only to add America to the list of nations with spreading deserts.

Lung associations, medical groups and environmentalists are very disturbed by the damage air pollution is causing on the health of our citizens, as demonstrated across the nation from smog-ridden Los Angeles to ozone-ridden Nashua, New Hampshire. Scientists are seriously bothered by the carbon dioxide increase in the atmosphere and the global warming effects. This buildup is caused mainly by overuse of the automobile whose carbon monoxide becomes CO_2 in the atmosphere.

In the daily gridlock around our cities people are wasting 1.6 billion hours a year. This waste of time and productivity may help explain why foreign goods are better made and more popular here. In these traffic jams the Department of Transportation projects that by the year 2005 Americans will waste seven billion gallons of fuel. Few leaders seem able to recall what OPEC did in 1973 and 1979. Our current waste of time, money and fuel has made us dependent on foreign oil exporters again. Oil imports account for a third of our nation's trade deficit.

In 1986 federal highway construction got $16,939,000,000 from non-user sources or more subsidy than Amtrak got in seventeen years. Air controllers and airports are publicly owned and supported. The Army Corps of Engineers, taxpayer supported, clears rivers for barge companies. Truck taxes do not cover the cost of the damage they do to highways and bridges. Trucks are getting a thirty-five per cent subsidy. Railroad companies have to lay track, install signals, build and maintain stations and pay property taxes all by themselves.

44,000 people die on our highways every year and 80,000 are permanently wounded by cars. Since the founding of Amtrak in 1971 over 795,000 people have died in auto accidents versus 42 people in Amtrak accidents. Between 1978 and 1986 over 10,000 people died in air crashes.

Consequently a major reorientation of our transportation policies is needed. To relieve gridlock the rebuilding of lightrail systems in all our major cities is essential. The electric streetcar is the one way to reduce pollution and health threats. To ease airport congestion highspeed rail between major city pairs is the logical solution. And to put the brakes on our waste of life and energy, a vast expansion of the rail passenger system is the answer.

Having spent hundreds of billions of dollars on highways and airports over the past thirty years, it is now time to start spending a tenth of that amount on relaying track, rebuilding passenger car plants, rebuilding dilapidated or non-existent railroad stations as transportation centers. Funding for such a program can come from one of two sources. The fairest one would be the creation of a general transportation budget for all modes, as in France. The secretary would then allocate the funds in such a way to develop a fair and balanced transportation system. The other funding source can be the designation of the first five cents of a gas tax increase as follows: one penny for Amtrak so it can order needed new equipment, run all trains daily, increase frequencies and revenue and expand the rail system; one cent for the Federal Railroad Administration so it will have funds to share with states for rail projects; and three more cents for mass transit so many more cities can reduce congestion, air pollution and waste of energy.

Either source of funds will surely help rebuild America and put it on a par with our European allies who have plans for big rail improvements. If we believe in a triad defense system - air, land and sea - which is one hundred per cent tax supported, why can't we believe in a triad transportation system - air, rail and road - fairly supported by the taxpayer?

Samuel E. Stokes Jr.
Board Member, National Association
of Railroad Passengers

January, 1989

A PROPOSAL

for Ending the Amtrak Debate

Proposal: Raise the federal gasoline tax one cent per gallon and designate the income for Amtrak.

Precedent: There is currently one federal cent allocated to mass transit.

Arguments:

1. The United States is the richest country in the world with the cheapest gasoline in the world. We can afford this penny.

2. With this one cent tax, Amtrax dependence on federal funds would vanish immediately and help reduce the deficit.

3. All existing trains could run daily and increase both ridership and revenue.

4. Major gaps in the current system could be closed.

5. Increased frequencies and eventually an expanded system serving millions of additional people would become possible.

Possible paragraphs in the Bill:

1. Ten per cent of the income must be used for track improvement and maintenance outside the Northeast Corridor.

2. Ten per cent of the income must be used for the purchase of new equipment until the passenger and engine fleet is adequate to serve the entire nation.

3. When improved track and equipment permit it, all 48 contiguous states shall have rail passenger service.

Conclusion: With the courage to pass such legislation, Congress will prepare this nation for an oil-short world, for energy conservation, for less acid rain and for cleaner air.

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Guest Editorial:

Do Increase The Gas Tax To Help Improve This Nation

Since it is a fact that the U.S. has the cheapest gasoline in the world and since we are the wealthiest nation in the world, we can afford an increase in the gasoline tax.

The current gas tax is 31 percent. In Britain it is 64 percent, in France 76 percent, in Denmark 78 percent. An annual five-cent increase for 10 years would be tolerable, especially since very few people will cut back on driving, whatever the cost of gasoline.

Since 44,000 people a year die on our highways and since 80,000 are permanently injured by cars, it is essential that we expand both mass transit and Amtrak in order to reduce this waste of life.

The first five-cent increase should be allocated as follows: one penny for Amtrak so it can order new equipment and expand its system; one penny to the Federal Railroad Administration so it will have funds to share with states for mass transit projects; and three cents for mass transit so we can reduce auto use, clean up our air, and put the brakes on global warming.

No one seems to be able to recall what OPEC did to us in 1973 and 1979. We are already back in the lap of foreign oil exporters. In the second quarter of this year we paid them $10.2 billion.

Certainly Americans should be willing to make a small gas tax sacrifice to help America get off its knees and stand tall again.

Samuel E. Stokes Jr. Alstead
Board Member, National Association of Railroad Passengers

THE RETURN OF THE PASSENGER TRAIN and JOBS

I. How many railroad and related jobs would be provided if the nations railroad beds were dramatically improved?

a) How many steel companies could produce welded rail for major and secondary lines?

b) How many steel companies could produce rail for the relaying of abandoned lines and for relaying double track where congestion is worst?

c) How many forest industries could make new ties?

d) How many quarries could produce new ballast?

e) How many wire companies could make fencing for the populous areas?

f) How many signal companies could make new equipment?

II. How many highway jobs would be provided if

a) overpasses and underpasses replaced most grade crossings?

b) other grade crossings were protected by automatic crossbars?

c) present overpasses were raised so piggyback freight, autotrains and dome cars could pass everywhere?

d) drive-on, drive-off docks for autotrain service were built near all major cities?

e) beautification projects were undertaken at the ugliest sights?

III. How many construction companies would have work if we rebuilt all our dilapidated or non-existent railroad stations as transportation centers for trains, buses and airport limousines?

IV. How many industries could make new passenger cars, new engines, new autotrain cars, new track work equipment?

Can the leaders of this nation be fair in their transportation thinking and funding allocations?

US Economic Policymakers As Stargazers

By Eliot Janeway

EVERY agency in the government power structure spends enormous sums on economic intelligence. Nevertheless, the record shows that America's public policymakers and corporate decisionmakers don't have a clue about the opportunities or obstacles confronting them abroad.

Take a golden export opportunity lost by default. Europe is as comfortable for money as America is uncomfortable. But Europe is acutely uncomfortable about two seemingly unrelated dislocations: airport congestion and unemployment. So Europe's priority agenda calls for using the money to soak up the unemployment by launching an ambitious new program to connect her cities with a checkerboard of high-speed "bullet trains." The channel tunnel connecting London and Paris is only the showcase example.

Europe is fixed in its protectionist ways. Despite Prime Minister Thatcher's brave clichés about free markets, the United Kingdom is also protectionist about using government money to buy jobs; she has just opted for a British tank over an American intruder, neither exactly needed to stand guard over the cliffs of Dover. But Europe's railroad equipment capacities cannot come close to handling projects of the magnitude being scheduled without massive import assistance. This opportunity has been some years in ripening, and Japan is ready to take advantage of it.

But America is not. She has given up on the railroad equipment business as passé. Historically, it has been a mainstay of American industrial power. Today it could have been revived again as a mainstay of American industrial export recovery, subject to no pressure to cut prices and sacrifice profits. But no one manning the intelligence conning tower in Washington passed the alert to anyone in the workshop. American industry was dreaming about the boom promised for "the information society" when Europe's industrial revival passed her by.

Now take a major opportunity to head off import competition. Airport congestion is not limited to Europe. America's mega-metropolitan airports paced her expansion until, midway through the 1980s, they stalled and turned into the major choke-points clogging her economic society. Consequently, commuter airlines feeding metropolitan airports have emerged as the fastest growing carriers. America now boasts 350 of them. Though a couple of domestic manufacturers of smaller aircraft are in dire straits, not one of these commuter airlines flies a plane made in the US. Even Northern Ireland and Brazil caught the sales signal that Washington failed to transmit to the industries that set their strategies by its leads.

Then, take the ordeal of Rustville. Washington missed a still bigger market signal that would have made all the difference in its crisis of the early 1980s.

Back then, Japan, as an act of policy, dismantled its basic aluminum and steel furnaces. Its strategy bet on the dynamic metal-using industries for export growth. Accordingly, it conceded Japan's domestic market for bulk metallics to countries counted on to make reciprocal purchases of Japanese automobiles, computers, electronics, and other end products for which she eyed mass export markets abroad.

America's decisionmakers don't have a clue about the opportunities or obstacles confronting them abroad.

So third-world orphans of the debt storm have become tough negotiators with Japan, exacting reciprocal trade deals in return for investment privileges to Japan for no reciprocal consideration. As proof of Washington's amateurishness at analysis and negotiation, the Venezuelas of the world have walked away with gilt-edged contracts to sell bulk tonnage of primary products in Japan while deferring debt payments to New York banks.

Finally, take the dollar devaluation of 1985. It was ballyhooed as the definitive key to competitiveness for the entire US economy, eliminating the pressure on any and all industries to scout and seize opportunities to outdo foreign competitors. Washington bet on the cheaper dollar to buy export customers for American industries saddled with uncompetitively high domestic costs. It failed to anticipate that the cheaper dollar would make Japan and America's other creditors a bargain basement gift of prime US assets.

This strategy has just been officially reversed. The US and its allies now spend billions to restabilize the dollar so blithely destabilized just over three years ago. The brave talk about devaluation staking out a new export boom is another write-off.

Sportswriters speak of "winning some, losing some," but the score piled up against Washington's forecasting establishment is a shutout. The record suggests that America's working people have been taking a bad rap for loafing on the job. In fact, it calls for criticism of America's economic policymakers for stargazing instead of focusing on realities. One way for President Bush to be assured of a good start is to check up on what his economic forecasters are looking at that isn't there.

■ *Eliot Janeway is the publisher of the Janeway Letter. His next book, "The Economics of Chaos: On Revitalizing the American Economy," will be published in February.*

The Cost of the Automobile

1983 - $341.8 billion to own and operate cars. (Hertz Corp.)

1983 - $40 billion loss in auto crashes. (Institute of Traffic Engineers)

1987 - $9 billion increase in oil imports. (New York Times, Nov. 19, 1987)

1987 - $3 billion in salt-induced road damage and vehicle corrosion. (New York Times, Nov. 12, 1987)

1987 - $2 billion; salty water threatening water supplies; killing hemlocks, pines, spruce; poisoning ponds, lakes and streams. (New York Times, Nov. 12, 1987)

1987 - A major contributor to ozone smog, posing severe health problems to people and toxicity to plants. (Environmental Action, March-April p. 18)

1987 - A major polluter, creator of acid rain and the greenhouse effect, producing one-half the total hydrocarbons, over three-quarters of the total carbon monoxide and nearly one-half of the nitrogen oxide emissions. (EPA, Region I, June 8, 1987)

1988 - The February jump in our nation's trade deficit included $3.9 billion for imported cars and a $300 million increase in payments to OPEC. (New York Times, April 15)

1988 - The May trade deficit included a $600 million increase in payments for imported oil. (New York Times, July 16)

1988 - In the second quarter of this year we paid foreigners $10.2 billion for oil. (New York Times, August 25)

1988 - The November trade deficit increased substantially to $12.5 billion. This included $3.1 billion for imported oil and $2.1 billion for Japanese cars. In other words our November trade deficit was 41.6 per cent auto-oil related. (New York Times, January 19,1989)